FEDERAL RESPONSE TO MARKET TURMOIL: WHAT'S THE IMPACT ON THE BUDGET

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FEDERAL RESPONSE TO MARKET TURMOIL: WHAT'S THE IMPACT ON THE BUDGET

WEDNESDAY, SEPTEMBER 24, 2008

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:10 a.m. in room 2103, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, DeLauro, Edwards, Cooper, Schwartz, Kaptur, Becerra, Berry, Boyd, Scott, Etheridge, Baird, Garrett, Hensarling, Conaway, Tiberi, and Porter,

Chairman SPRATT. Mr. Ryan apparently is in a meeting and will be here shortly. In the interest of time, I will proceed by opening the hearing, welcoming our witness, and making my opening statement.

Last Thursday Secretary Paulson, Chairman Bernanke and the Chairman of the SEC, Chris Cox, came to the Capitol to brief the leadership of the Congress on the financial crisis facing our country and to ask for a swift, robust response by Congress.

On Saturday they followed up that meeting with a legislative proposal, or at least a skeletal outline of the bookends of a proposal, with the contents to follow, along with a dire warning that time was of the essence.

Since then, Congress has been poring over the Bush administration proposal, making various improvements to it and trying to find common ground for consensus. On the Budget Committee we have a limited role in legislating the proposal before us, even though it has major repercussions for the budget.

Just 2 weeks ago the Congressional Budget Office released its updated economic forecast and warned us of large, unrelenting deficits that lie ahead of us. Economic events since then have only worsened the outlook. The Bush administration requested an unprecedented sum, $700 billion, to shore up failing firms, to stop panic in the financial markets, and to keep the economy from backsliding into a protracted recession.

Our hearing today will examine the impact of the President's request on the budget. The President has called for Congress to act with dispatch, but we must also act with diligence and deliberation as we consider his request, and that is the purpose of today's hearing.

To that end I decided yesterday—and Mr. Ryan graciously agreed—to move this hearing up from its scheduled time on Friday. Although the time for full consideration has not yet been set, I was concerned that a hearing on Friday would come after the bill was considered on the floor. I want to commend the staff of the Budget Committee on both sides of the aisle, Democrats and Republicans, Tom Kahn and Austin Smythe, who have been working in a collegial bipartisan way to analyze the proposals that were sent to us.

We were concerned that the proposal in its original form did not adequately account for market risk and, therefore, understated costs. Our staff has been working with the staff at OMB on the proposed scoring of this proposal so that it better reflects the market risk involved.

Budget Committee staff have also helped to add to the bill periodic requirements for the reporting of funds dispersed, assets acquired, and the estimated recovery or repayment of those assets.

Our witness today is Peter Orszag, the Director of the Congressional Budget Office. I want to thank Dr. Orszag for rearranging his schedule on short notice so that he could testify.

I also want to thank his staff for all they have done to help us analyze this proposal. CBO has been working overtime on written testimony, and most of our members probably did not see the testimony of Dr. Orszag until they arrived here this morning. I would encourage everybody to read it because it is an excellent statement of the situation. And I would also encourage Dr. Orszag to take whatever time he needs to give us a thorough, complete analysis of how CBO analyzes a request and how it should be reflected in the budget.

Just by way of background, let me lay out the budget question that is mainly before us. There are two conventions for recording the President's $700 billion request, should it be granted. Under traditional scoring, when the Federal Government purchases an asset, the purchase payment is shown in the budget as an outlay. But there is no corresponding entry for the value of the asset acquired, not at least until the asset is sold. When it is sold, the sale price is booked as an offsetting receipt or a negative outlay. If CBO follows this method, this convention, it needs to know various things: How much of the $700 billion will be drawn down by the Treasury and paid out and when that withdrawal will occur? And to complete the transaction CBO needs to know when the asset is sold and the receipts that are derived from the sale. Obviously these things are difficult to know at this point in time.

If the government's disbursement takes the form of a loan, the loan amount is not booked as an outlay and the subsequent repayments are not booked as receipts.

Under the Federal Credit Reform Act, if the loan is deemed likely to repay on a present-value basis less than the original principal amount because of losses or subsidies, then CBO books a probable shortfall does not lay in the year the loan is made. OMB believes that the request of $700 billion should be scored in this matter because many of the assets the government acquires will be mortgage loans, so the government will be stepping into the shoes of the mortgagee.

As you can see, the customary accounting conventions are not an easy fit for the circumstances we find ourselves in. Yet the convention used can have a major impact on how the requested $700 billion is incorporated into the budget.

Our purpose is to explore these and other budget process issues with Dr. Orszag. And in that connection, let me remind all of our members that Dr. Orszag is not here to oppose or support this proposal before us. He and his staff are here as analysts, not advocates.

Before turning to Dr. Orszag I would normally turn to our Ranking Member, Mr. Ryan. I understand that he will reserve his place to make an opening statement. It is going to be a closing statement, after Dr. Orszag has testified.

Dr. Orszag, I think the better part of wisdom is to proceed with your testimony. Thank you for being here. And your testimony is an excellent statement of the situation of the choices before us, and I would encourage you to take all the time you need to thoroughly explain it to the members of this committee. Thank you once again for your excellent contribution to our effort.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ORSZAG. Thank you, Mr. Chairman, members of the committee. Since August 2007, financial markets have experienced severe strains which emanated from the bursting of the housing bubble and then fed into declines in mortgage-related assets, which then fed into significant difficulties in ascertaining the financial condition of the institutions holding such securities. These problems contributed to a broader collapse of confidence, with the result of financial institutions having become increasingly unwilling to lend to one another.

Over the past few weeks, the collapse of confidence in financial markets has become particularly severe. I have a chart that I would like to put up which shows one illustration of that collapse of confidence in financial markets.

This shows, in a sense, the higher you go on that curve, the more turmoil there is in short-term financial markets. And that spike that you see occurred over the past couple of weeks. So a very dramatic collapse, which is what drove the Treasury Department to propose the act that is under consideration.

One thing that is striking is the turmoil in the financial markets thus far has had less impact on macroeconomic activity than one might have thought, and indeed the second quarter showed fairly robust economic growth. A modern economy like the United States, however, depends crucially on the effective functioning of its financial markets in order to operate. And there is little doubt that if the kinds of strains that are shown in that graph were perpetuated, the effects on economic growth, on household income, and on other things that we all care about would be quite severe if not devastating.

To mitigate these risks the Treasury Department and others have put forward a variety of proposals. In analyzing them it is crucially important to keep distinct two problems. One is that the markets for some types of assets have effectively stopped functioning; that there is illiquidity in particular financial markets. For that kind of issue, the Federal Government could intervene as a market maker to reestablish liquidity. And that need not—and I am going to return to this later—that need not involve any significant subsidy from the Federal Government to private market institutions.

The second problem, though, involves the potential insolvency of specific financial institutions. By some estimates, global commercial banks and investment banks may need to raise hundreds of billions of dollars more to cover their losses. Restoring solvency to insolvent institutions requires additional capital investment, and one possible source of such capital injections is the Federal Government.

These two problems are related in the sense that it is difficult to know which institutions are insolvent if you can't price their assets because of illiquidity in the markets; and, conversely, injecting more equity into insolvent or barely solvent financial institutions could help to restore liquidity to some financial markets because each counterparty may be more willing to lend to another financial institution with more confidence that there is a greater capital cushion at that other financial institution to which it would be lending.

Nonetheless, the problems are, even though they are related, conceptually distinct, and much of the policy discussion about the Treasury proposal and other recent proposals have muddled or confused the two issues. Indeed, some proposals appear to be aimed primarily at the illiquidity of particular asset markets; others seem to be aimed primarily at insolvency; and some may do a little bit of both, depending on how they are implemented.

Given that, let me turn in particular to the troubled Asset Relief Act of 2008 as proposed by the administration. As you know, the act would authorize the Secretary of the Treasury to purchase, hold, and sell a wide variety of financial instruments, particularly those that are based on or related to mortgages issued prior to September 2008. The legislation would appropriate such sums as are necessary to enable the Secretary to purchase up to $700 billion of such assets at any point during the 2-year window of opportunity specified under the legislation and to cover relevant administrative expenses.

At this time, given the lack of specificity regarding how the program would be implemented and even what classes would be purchased by the Secretary, CBO cannot provide a meaningful estimate of the ultimate net cost of the administration's proposal. The Secretary would have the authority to purchase virtually any asset at any price and sell it at any future date.

The lack of specificity regarding how that authority would be implemented makes it impossible at this point to provide a quantitative analysis of the net costs to the Federal Government. Nonetheless, some observations are possible with regard to what would influence the net cost to the Federal Government.

And I would identify two key forces. The first is whether the Federal Government seeks and is able to succeed in obtaining a fair price for the assets it purchases, and in particular whether it can avoid being saddled with the worst credit risk without the purchase price reflecting those risks. I am going to return to that in a moment.

The second force is whether, because of severe market turmoil, market prices are currently lower than the underlying value of the assets. If current prices reflect so-called fire-sale pricing that can result from severe liquidity constraints and impairment of credit flows, taxpayers could possibly benefit by buying now, holding the securities, and selling them as prices return to those underlying values.

But let me return to that first force and whether the Federal Government will obtain a fair price for the assets that it is purchasing. That will depend not only on the types of assets that are purchased, but how the transactions are conducted. The Treasury has indicated that it would conduct reverse auctions for at least some of the purchases. And I would note a reverse auction can work well in some cases, but it is not magic. It only works well under certain conditions; in particular, under a reverse auction, the sellers offer to sell you something and someone will offer—I will sell it to you for $100, someone else will say $90, someone else will say $80. And instead of a regular auction where the price goes up, the price goes down, so that you get the lowest bidder winning the contract, thereby getting the best price possible as a buyer. Thus, a reverse auction.

In the context of financial assets a reverse auction works best when different sellers are offering to sell their shares in the same asset rather than offering to sell different assets, and also when many sellers participate. When sellers are offering different assets, the lowest bidder may win by offering an asset with particularly risky or poor future prospects and the price may not reflect the degree to which the specific asset is impaired or risky.

Consequently, the Federal Government could purchase too many risky or impaired assets without enjoying sufficient price discounts.

Similarly, if the number of bidders or participants is unduly limited, the government could overpay relative to a fair price. One focus the Treasury has identified for the program is mortgage-backed securities, and they have indicated that they may conduct reverse auctions on a tranche-by-tranche basis, that is on a CUSIP-by-CUSIP basis for each individual cash flow associated with the mortgage-backed security. Reverse auctions on that basis. That would work relatively well.

And to the extent that the program was limited to that kind of auction for that kind of security done in that kind of way, you are likely to get a price that reflects the underlying characteristics of the cash flows that the Federal Government would be purchasing.

Reverse auctions may not obtain a fair price for the government for many other types of assets that may be covered under the program, though. In particular, for example, if the Federal Government went out and bought loans themselves from banks, you are very likely to wind up with the worst quality within any given risk classification and to wind up overpaying for those individual assets.

Basically the problem there is that the seller has more information than you do about the characteristics of the asset and there is no way that a reverse auction can ensure that you are obtaining a sufficiently low price for the risk characteristics of what you are purchasing. Substantial purchases of those types of assets would make it unlikely that the Treasury could operate the proposed new program at little or no net cost to the taxpayer.

In other words, the more that the Treasury program concentrates on assets that are difficult for a buyer to value, the more likely that the government will overpay. And the more that that occurs, the more the program moves beyond simply reestablishing trading in illiquid financial markets, and the more it instead subsidizes particular financial institutions selling those assets to the government in a manner that seems unlikely to be an efficient approach to addressing concerns about insolvency.

The written statement includes some discussion of alternative proposals including direct equity injections. I would be happy to answer questions about that. But especially since I see that Mr. Ryan is now here, I will end my oral statement with that. Thank you very much Mr. Chairman.

[The prepared statement of Peter R. Orszag follows:]

PREPARED STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Spratt, Ranking Member Ryan, and Members of the Committee, thank you for inviting me to testify this morning on the budgetary and economic implications of the recent turmoil in financial markets and the Administration's proposal to address it.

Since August 2007, the Federal Reserve and the Treasury have been attempting to address a series of severe breakdowns in financial markets that emanated from the bursting of the housing bubble, leading to substantial losses on mortgage-related securities and great difficulty in accurately ascertaining the financial condition of the institutions holding such securities. Those problems generated significant increases in risk spreads (or the interest rates charged on risky assets relative to Treasury securities) but, more important, contributed to a broader collapse of confidence, with the result that financial institutions became increasingly unwilling to lend to one another.

Over the past several weeks, the collapse of confidence in financial markets has become particularly severe. Short-term loans between financial institutions have fallen off sharply. Instead, the Treasury and the Federal Reserve have become the financial intermediaries for them. In other words, rather than financial institutions with excess money lending to institutions needing short-term funding, many institutions with excess short-term money have purchased Treasury securities, the Treasury has placed the proceeds on deposit at the Federal Reserve, and the Federal Reserve has then lent the money out to those institutions needing short-run funding.

Thus far, turmoil in the financial markets has had less impact on macroeconomic activity than may have been expected, and, indeed, economic growth was relatively strong in the second quarter of this year—in part because of the stimulus package enacted earlier this year. A modern economy like the United States', however, depends crucially on the functioning of its financial markets to allocate capital, and history suggests that the real economy typically slows some time after a downturn in financial markets. Moreover, ominous signs about credit difficulties are accumulating. The issuance of corporate debt plummeted in the third quarter, and the short-term commercial paper market has also been hit hard. Bank lending, which has thus far remained relatively strong, will undoubtedly be severely curtailed by the difficulties that banks are facing in raising capital. Such a curtailment of credit means that businesses and individuals will find it increasingly difficult to borrow money to carry out their normal activities. In sum, the problems occurring in financial markets raise the possibility of a severe credit crunch, which could have devastating effects on the U.S. and world economies.

To mitigate the risks, the Department of the Treasury has proposed the Troubled Asset Relief Act of 2008, and similar proposals have also been put forward by the Chairman of the House Financial Services Committee and the Chairman of the Senate Banking Committee. In an analysis of these proposals, it is useful to identify two problems facing financial markets: illiquidity triggered by market panic and the potential insolvency of many financial institutions.

One problem is that the markets for some types of assets and transactions have essentially stopped functioning. To address that problem, the government could conceivably intervene as a "market maker," by offering to purchase assets through a competitive process and thereby provide a price signal to other market participants. (That type of intervention, if designed carefully to keep the government from overpaying, might not involve any significant subsidy from the government to financial institutions.) The second problem, though, involves the potential insolvency of specific financial institutions. By some estimates, global commercial banks and investment banks may need to raise a minimum of roughly $150 billion more to cover their losses. As of mid-September 2008, cumulative recognized losses stood at about $520 billion, while the institutions had raised $370 billion of additional capital.[1] Restoring solvency to insolvent institutions requires additional capital injections, and one possible source of such capital is the federal government.

Those two problems are related in the sense that it is difficult to know which institutions are insolvent without being able to value the assets they hold (which in turn is impeded by illiquid markets). Undisclosed losses are unlikely to be distributed uniformly throughout the financial system, and the inability to identify which institutions are carrying the largest losses has led to a breakdown of trust in the entire financial sector.[2] That loss of trust has sharply increased the cost of raising capital and rolling over debt, which threatens the solvency of all financial institutions. Injecting more capital into financial institutions could help to restore liquidity to some financial markets, because, with larger cushions of capital to protect against default, the institutions would be more willing to lend to one another. Another linkage between these two problems could occur if some institutions are unwilling to sell assets at current market prices if that then triggered the recognition of accounting losses; such reluctance to sell can contribute to illiquid markets. With additional equity, those institutions may be more willing to sell at current market prices even if that required recognizing losses.

Although the problems of illiquidity and insolvency are interrelated, they are at least conceptually distinct. Indeed, some policy proposals appear to be aimed primarily at the illiquidity of particular asset markets, and others appear to be aimed primarily at the potential insolvency of specific financial institutions.

Most of this testimony examines the Troubled Asset Relief Act of 2008. That act appears to be motivated primarily by concerns about illiquid markets. The more the government overpays for assets purchased under that act, however, the more the proposed program would instead provide a subsidy to specific financial institutions, in a manner that seems unlikely to be an efficient approach to addressing concerns about insolvency.

THE TROUBLED ASSET RELIEF ACT OF 2008

The Congressional Budget Office (CBO) has reviewed the Troubled Asset Relief Act of 2008, as proposed by the Administration. The act would authorize the Secretary of the Treasury to purchase, hold, and sell a wide variety of financial instruments, particularly those that are based on or related to residential or commercial mortgages issued prior to September 17, 2008. The authority to enter into agreements to purchase such financial instruments, which the proposal refers to as troubled assets, would expire two years after its enactment.

The legislation would appropriate such sums as are necessary, for as many years as necessary, to enable the Secretary to purchase up to $700 billion of troubled assets at any point during the two-year window of opportunity (though cumulative gross purchases may exceed $700 billion as previously purchased assets are sold) and to cover all administrative expenses of purchasing, holding, and selling those assets. The federal debt limit would be increased by $700 billion.

At this time, given the lack of specificity regarding how the program would be implemented and even what asset classes would be purchased, CBO cannot provide a meaningful estimate of the ultimate net cost of the Administration's proposal. The Secretary would have the authority to purchase virtually any asset, at any price, and sell it at any future date; the lack of specificity regarding how that authority would be implemented makes it impossible at this point to provide a quantitative analysis of the net cost to the federal government.

THE BUDGETARY TREATMENT OF THE PROPOSAL

The federal cost of the proposal could be reflected in the budget either on a cash basis or on a net-expected-cost basis. The proposal would require that the federal budget display the costs of this new activity under the latter approach, using procedures similar to those contained in the Federal Credit Reform Act (but adjusting for market risk in a manner not reflected in that law). In particular, the federal budget would not record the gross cash outlays associated with purchases of troubled assets but, instead, would reflect the estimated net cost to the government of such purchases (broadly speaking, the purchase cost minus the expected value of any estimated future earnings from holding those assets and the proceeds from the eventual sale of them). That approach would be similar to the current budgetary treatment of a broad array of loans and loan guarantees made by the federal government, wherein the best measure of the cost to the government reflects not only initial disbursements but also the resulting cash flows in future years.

In CBO's view, that budgetary treatment best reflects the impact of the purchases of financial assets on the federal government's underlying financial condition. The fundamental idea is that if the government buys a security at the going market price, it has exchanged cash for another asset ratherthancausedadeteriorationin its underlying fiscal position.

CBO expects that the Treasury would probably fully use its $700 billion authority in fiscal year 2009 to purchase various troubled assets. To finance those purchases, the Treasury would have to sell debt to the public. Federal debt held by the public would therefore initially rise by about $700 billion. Nevertheless, CBO expects that, over time, the net cash disbursements under the program would be substantially less than $700 billion, because, ultimately, the government would sell the acquired assets and thus generate income that would offset at least much of the initial cost.

Whether those transactions ultimately resulted in a gain or loss to the government would depend on the types of assets purchased, how they were acquired and managed, and when and under what terms they were sold. In addition to the future evolution of the housing prices, interest rates, and other fundamental drivers of asset values, two key forces would influence the net gain or loss on the assets purchased:

- Whether the federal government seeks and is able to succeed in obtaining a fair market price for the assets it purchases and, in particular, whether it can avoid being saddled with the worst credit risks without the purchase price reflecting those risks. Concerns about the government's overpaying are particularly salient when sellers offer assets with varying underlying characteristics that are complicated to evaluate. As discussed further below, such problems are attenuated the more that the government focuses on buying part of a given asset from institutions that all own a share of that asset, rather than buying different assets from different institutions. That is, the government is more likely to pay a fair price when multiple institutions are competing to sell identical assets than when it has to assess competing offers for different assets with hard-to-determine values.
- Whether, because of severe market turmoil, market prices are currently lower than the underlying value of the assets. If current prices reflect "fire sale" prices that can result from severe liquidity constraints and the impairment of credit flows, then taxpayers could possibly benefit along with the institutions selling the assets. Under normal circumstances, prices do not long depart from their fundamentals because the incentive to engage in arbitrage and profit from price discrepancies is large. But arbitrage practices work less well when liquidity is restrained, as it is now, and many potential arbitragers cannot get short-term financing.[3] It is therefore at least possible that the prices of some assets are below their fundamental value; in that case, to the extent that the government bought now and held such assets until their market prices recovered to reflect that underlying value, net gains would be possible.

In addition to any net gain or loss on the purchase of $700 billion or more in assets, the government would also incur significant administrative costs for the proposed program. Those costs would depend on what kinds of assets were purchased. On the basis of the costs incurred by private investment firms that acquire, manage, and sell similar assets, CBO expects that the administrative costs of operating the program could amount to a few billion dollars per year, as long as the government held all or most of the purchased assets

The proposed program could affect other federal programs—including, for example, the operations of Fannie Mae, Freddie Mac, federal housing programs, and deposit insurance. The program's impact on the future costs of other federal programs would depend on what kinds of assets were acquired and from what types of institutions and on how successful the program was in restoring liquidity to the nation's financial markets.

DETERMINING A PURCHASE PRICE FOR TROUBLED ASSETS

The legislation would authorize the Secretary to purchase almost any conceivable type of asset related to residential or commercial mortgages, from individual loans to complex insurance products, and possibly other assets not directly related to such mortgages. The Treasury Department has indicated that it would conduct reverse auctions for at least some of the purchases. In a reverse auction, many potential sellers would bid on the price to be accepted by the government, and the lowest bidders would win. Using a reverse auction process in which multiple sellers compete to offer the Treasury the lowest price for a set volume of similar troubled assets would help ensure that the government was paying a fair price for those assets.

In the context of financial assets, a reverse auction works best when (1) different sellers are offering to sell their shares in the same asset rather than offering to sell different assets and (2) when many sellers participate. When sellers are offering different assets, the lowest bidder may win by offering an asset with particularly risky or poor future prospects, and the price may not reflect the degree to which that specific asset is risky or impaired. Consequently, the federal government could purchase too many risky or impaired assets without enjoying sufficient price discounts. Similarly, if the number of participants in the reverse auction is unduly limited (either because few institutions own the asset that the government wants to purchase or because few owners choose to participate in the auction), the government could overpay relative to a fair price.

One focus of the Treasury program seems likely to be mortgage-backed securities (MBSs), which are ownership shares in large pools of individual mortgages. Financial institutions own hundreds of thousands of such securities, reflecting more than $7 trillion in pooled mortgage assets; most of the hard-to-value MBS assets are likely to be in the nearly $3 trillion not owned or insured by Fannie Mae and Freddie Mac. The Treasury Department has indicated that the reverse auctions for MBS assets might be conducted security by security—that is, there would be a separate "mini-auction" for each tranche of the MBSs.[4] If those tranches were widely distributed across financial institutions and if the government offered to purchase only a small share of each tranche, the result should be that the government would obtain a fair price for such purchases.[5]

Reverse auctions may not obtain a fair price for the government for many other types of assets the Treasury may seek to purchase. In particular, determining fair market prices using an auction is difficult for assets that are not clearly the same or very similar in quality—that is, when the seller has more information about the quality of the asset than the buyer does. In such cases, each auction participant will offer up assets with unique attributes known only to the seller, thus increasing the likelihood that the government will pay too much. That type of problem is likely to be particularly severe for assets like individual home mortgages or esoteric derivative products entirely owned by specific financial institutions.[6] Substantial purchases of such assets would make it unlikely that the Treasury could operate the proposed new program at little or no net cost.

In other words, the more that the Treasury program concentrates on assets that are difficult for a buyer to value, the more likely that the government will overpay. The more that occurs, the more the program moves beyond simply reestablishing trading in illiquid financial markets and instead subsidizes the particular financial institutions selling assets to the government, at a cost to taxpayers.

FINANCIAL MARKET AND OTHER EFFECTS OF THE PROPOSAL

The Treasury's proposal is aimed at stabilizing financial markets and the economy by providing liquidity to support credit flows. One reason that credit markets have seized up is the uncertainty about who holds impaired assets and what they are worth, especially those related to mortgages. The underlying losses on those assets reflect the decline in home prices, but the mortgage loans have been repackaged as MBSs and then again into more complex securities such as collateralized debt obligations and credit default swaps that have spread the risk across many financial markets.

The proposal would allow the Treasury to buy up those assets regardless of the form in which they are held. The core problem, though, has moved beyond the mortgage markets and has become a broader collapse of confidence in financial markets. It therefore remains uncertain whether the program will be sufficient to restore trust, especially if the program is limited to the asset classes in which the government is least likely to overpay for its purchases.

At the same time, intervention on a massive scale is not without risks to taxpayers and to the economy.[7] Almost by definition, the intervention cannot solve insolvency problems without shifting costs to the taxpayers. Ironically, the intervention could even trigger additional failures of large institutions, because some institutions may be carrying troubled assets on their books at inflated values. Establishing clearer prices might reveal those institutions to be insolvent. (To the extent such insolvencies were revealed, the net effect might not be deleterious. Providing more transparency about the lack of solvency at specific institutions may be necessary to restore trust in the financial system.)

More broadly, there is an inherent tension between minimizing the costs to taxpayers and pursuing other policy goals. For example, as the manager of troubled mortgage assets, the government would be likely to come under intense pressure to avoid foreclosures or to take other steps to pursue goals for low-and moderate-income housing through activities that would not be subject to the constraints of the normal budget process. Those objectives may benefit specific homeowners, at the expense of taxpayers as a whole.

ALTERNATIVES TO THE TREASURY'S PROPOSAL

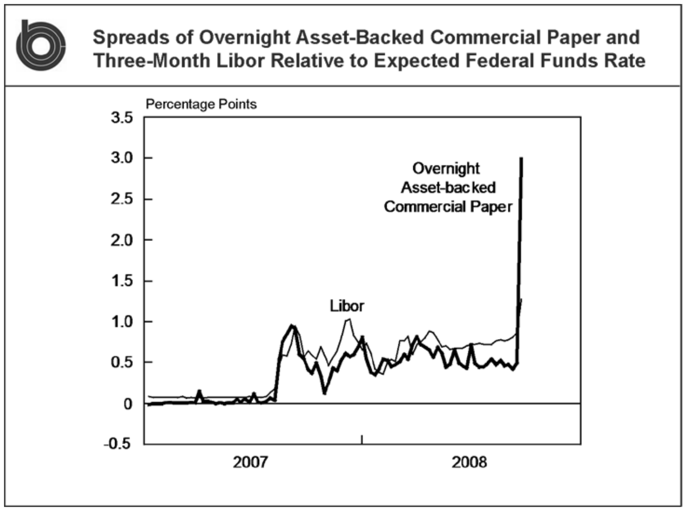
Some analysts, in assessing the Treasury's proposal, have pointed out that other recent actions by the Federal Reserve and the Treasury have given taxpayers significantly more upside in the form of equity stakes in the companies that receive assistance. Those actions have been aimed at supporting particular troubled institutions, rather than at enhancing the liquidity of the financial markets. Under some alternative proposals, the government would receive shares in an institution if it ultimately lost money on the sale of assets purchased from the institution. That approach would reduce the risk of overpaying for securities if the seller had more information about the value of those securities than the Treasury did. However, institutions that gave up equity would presumably expect to receive higher prices for their assets, and an equity stake in the firms might not offer any better upside to taxpayers than direct purchases of the assets on a risk-adjusted basis. Furthermore, healthy institutions might be deterred from participating, which could make it more likely that the federal government would overpay for assets by limiting the potential number of sellers—and the potential dilution for existing shareholders if asset prices declined in the future might make it challenging for financial institutions that issued such equity to the government to raise private capital in the future.

An alternative approach that is more directly aimed at addressing insolvency concerns is for the government to invest directly in financial institutions to strengthen their capital positions, without directly purchasing troubled assets. The injections could take the form of preferred stock, which would effectively lower the cost of new capital for the institutions. Such proposals could be modeled along the lines of the Reconstruction Finance Corporation, a Depression-era institution.

A number of twists to that approach have been offered. Some versions require that the institutions match the injection with new private funds in the form of common stock. In addition, some require that the underwriting risk associated with raising new capital be mutualized by the group of participating institutions acting as a syndicate. The syndicate would be responsible for at least half of the underwriting burden, which would give it an incentive to limit membership to solvent institutions only. Participating banks might also be required to suspend dividends, which would increase their retained earnings and thus add directly to capital. (Although institutions can always cut their dividends, doing so usually sends a bad signal to financial markets. A requirement could dilute the effect of that bad signal.)

Such proposals have some advantages:[8]

- They provide some upside to taxpayers in the form of dividends and capital gains on preferred stock. Under some proposals, the payments of dividends to the government would be deferred.
- They avoid the challenge of pricing and then selling individual assets (although they raise the issue of how to price the equity shares the government offers to purchase).
- They avoid rewarding the firms that have made the worst investment decisions.
- They keep the government as a minority shareholder. The firms' managers would continue to run the firms on a profit-maximizing basis, thereby mitigating the risks of the government using its equity positions to pursue a range of public policy goals.
- They could impose losses on shareholders and changes in management. Such plans have some disadvantages though:
- They fail to address directly the illiquidity problems for some assets and the associated uncertainty.
- The assistance may not be targeted to the institutions most in need of help, and the firms that most need capital may be most reluctant to take it.
- The approach could inject additional funds into institutions whose business model is no longer viable. Past experience suggests that extending the operations of insolvent institutions may increase the ultimate cost to taxpayers.
- The proposals raise difficult questions about eligibility criteria. For example, would finance companies that are part of large diversified holding companies be eligible?



Spreads of Overnight Asset-Backed Commercial Paper and Three-Month Libor Relative to Expected Federal Funds Rate

ENDNOTES

[1] Figures are from Bloomberg as of September 22, 2008. For institutions located in the Americas, recognized losses are about $260 billion, while the amount of additional capital raised to date is $180 billion, which leaves a gap of about $80 billion.

[2] Anil K. Kashyap, Raghuram G. Rajan, and Jeremy C. Stein, “Rethinking Capital Regulation” (paper presented at the Federal Reserve Bank of Kansas City symposium on “Maintaining Stability in a Changing Financial System, Jackson Hole, Wyo., August 21—23, 2008), available at *www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.09.15.08.pdf.*

[3]. Andrei Shliefer and Robert W. Vishny, “The Limits to Arbitrage,” JournalofFinance, vol. 52, no. 1 (1997), pp. 35—55.

[4] Rights to the income from the pool of mortgages are divided up into slices, or tranches. The senior tranches will get paid under almost all circumstances; the most junior tranches will take the first risk of loss of income from defaults on the underlying mortgages. Each tranche is identified by a standard CUSIP (Committee on Uniform Security Identification Procedure) number like any other publicly traded security. Pieces of each tranche are likely to be held by many institutions, some troubled, some not.

[5] For further discussion of efficient auction designs, see Lawrence M. Ausubel and Peter Cramton, “Auction Design Matters for Rescue Plan.”

[6] Such problems could be attenuated by requiring that private capital pools run by the asset managers hired by the government under the program participate in some share of each purchase made by the government.

[7] Douglas W. Elmendorf, Concerns About the Treasury Rescue Plan (September 19, 2008), available at *www.brookings.edu/opinion/2008/0919—treasury-plan-elmendorf.aspx.*

[8] Ibid.

Chairman SPRATT. Let me now turn to Mr. Ryan for his opening statement.

Mr. RYAN. Thank you, Mr. Chairman. I apologize for being late. As you know, there are a lot of meetings going on in this building right now, to which many of us are attending. This a real serious situation. By nearly all accounts, the turmoil in our financial markets last week was unprecedented in recent history. Clearly, and I think rightly, Americans are genuinely worried. And all of us here, Republicans and Democrats, are very concerned about the situation we find ourselves in. We know that our markets are in serious trouble.

And we also need to understand that this just isn’t a problem for Wall Street. It is also a problem with potential harm to our entire economy. And everyone and everything from small businesses to workers to senior retirement accounts are at risk here. I think there will be an endless debate over the next few months, maybe years, as to how we got to this point. And there are certainly many contributing factors. But clearly, two of the biggest are, number one, a monetary policy that kept interest rates artificially low and encouraged imprudent and often outright reckless borrowing and lending.

Number two, Fannie and Freddie's buildup of investment portfolios to boost profits, all at the risk and unlikely expense of the taxpayers.

For the past few months, Congress and the administration has scrambled to address each of these episodes dealing with whichever crisis had come to a head at the moment, but not really doing anything to address the underlying problem and thus prevent the next crisis from popping up.

This week, of course, we are all working with the administration and with Treasury to deal with this crisis. The administration has proposed an ambitious unprecedented plan to address this problem and to stem some of the fallout to the larger economy. The plan would provide Treasury the authority to purchase up to $700 billion in private mortgage-backed securities. And, yes, I have genuine concerns about giving Treasury, or anyone, that kind of authority.

Finally—and a primary concern to this committee—what is all of this going to mean to the Federal budget?

Dr. Orszag, I know that at this point the most accurate answer to this question is probably we just don't know. But that said, this is the business of this committee. We are going to have to figure this out. And I very much appreciate, Dr. Orszag, you doing your best today, under the circumstances, to give this committee your best assessment of the potential impact of the bailout legislation working its way through Congress this week.

And Mr. Chairman I thank you for indulging me with the opening statement. I appreciate it.

Chairman SPRATT. Thank you, Mr. Ryan.

Before turning to questions for our witness, I would ask unanimous consent that all members be allowed to submit an opening statement for the record at this point if they so choose. Without objection, so ordered.

[Congressional Research Service report, submitted by Mr. Spratt, follows:]

PREPARED STATEMENT OF BAIRD WEBEL, N. ERIC WEISS, AND MARC LABONTE, GOVERNMENT AND FINANCE DIVISION, CONGRESSIONAL RESEARCH SERVICE

SUMMARY

In response to ongoing financial turmoil that began in the subprime mortgage-backed securities market, the federal government has intervened with private corporations on a large scale and in an ad hoc manner three times from the beginning of 2008 through September 19, 2008. The firms affected were Bear Stearns, Fannie Mae and Freddie Mac, and AIG. Another large investment bank, Lehman Brothers, sought government intervention, but none was forthcoming; subsequently, the firm sought bankruptcy protection.

These interventions have prompted questions regarding the taxpayer costs and the sources of funding. The sources of funding are relatively straightforward, the Federal Reserve (Fed) and the U.S. Treasury. The costs, however, are difficult to quantify at this stage. In the most recent interventions (Fannie Mae and Freddie Mac, and AIG), all the lending that is possible under the interventions has yet to occur. Also, in all the current cases, the government has received significant debt and equity considerations from the private firms. At this point, Fannie Mae, Freddie

Mac, and AIG are essentially owned by the federal government. Depending on the proceeds from the debt and equity considerations, the federal government may very well end up seeing a positive fiscal contribution from the recent interventions, as was the case in some of the past interventions summarized in the tables at the end of this report. The government may also suffer significant losses, as has also occurred in the past.

This report will be updated as warranted by legislative and market events.

WHERE HAS THE MONEY COME FROM?

In the recent interventions, there have been two primary sources of funding: the Federal Reserve (Fed) and the U.S. Treasury. The Fed has the general authority under its founding statute to loan money "in usual and exigent circumstances" to "any individual, partnership, or corporation" provided five members of the Board of Governors of the

Federal Reserve system agree.[1] This authority has been cited in two of the three interventions this year, Bear Stearns and AIG. The source of money loaned under this section derives from the Fed's general control of the money supply, which is essentially unlimited subject to the statutory mandates of controlling inflation and promoting economic growth.[2] Since the profits of the Fed are ultimately remitted to the Treasury, the indirect source of the funds is the Treasury. In the case of Fannie Mae and Freddie Mac, the direct source of funding is the Treasury, pursuant to the statutory authority granted in the Housing and Economic Recovery Act of 2008.[3]

THE COST OF FINANCIAL INTERVENTIONS

Determining the cost of government interventions, particularly those currently in progress, is not straightforward. Assistance often comes in forms other than direct monies from the Treasury, including loan guarantees, lines of credit, or preferred stock purchases, which may have little or no initial cost to the government. A loan guarantee, which can be thought of as a sort of insurance, has value even if it is never used. Many insurance policies are never used, but individuals and companies purchase them to reduce risk of loss. In many past cases, the value to various companies of federal guarantees was to allow them to access the private credit markets, issuing bonds or obtaining bank loans that they would not otherwise have been able to obtain. In other past cases, the federal guarantee resulted in a lower interest rate on the bonds or loans.

Depending on the conditions attached to each specific intervention and how events proceed thereafter, the government may even see a net inflow of funds from the actions taken, rather than a net outflow. The summaries below address the maximal amounts promised in federal assistance and attempt to quantify the amounts that have actually been disbursed, although particularly in the most recent cases (Fannie Mae and Freddie Mac, and AIG), there is little information as to the exact amounts disbursed. There are also other, more diffuse costs that could be weighed. For example, many would argue that the cost to the taxpayers of any intervention should be weighed against the potential costs of financial system instability resulting from inaction, or that one intervention may lead to more private sector risk-taking, and thus necessitate additional future interventions (moral hazard). Such costs, however, are even harder to quantify than the realized cost of the interventions. This report does not attempt to address them.

RECENT FINANCIAL INTERVENTIONS

AIG

On September 16, 2008, the Fed announced that it was taking action to support AIG, a federally chartered thrift holding company with a broad range of businesses, primarily insurance subsidiaries, which are state-chartered. This support took the form of a secured two-year line of credit with a value of up to $85 billion. The interest rate on the loan is relatively high, approximately 11.5% on the date it was announced. In addition, the government received warrants to purchase up to 79.9% of the equity in AIG. According to the Fed, $28 billion has been lent to AIG as of September 18, 2008.[4]

Fannie Mae and Freddie Mac [5]

On September 7, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship. As part of this conservatorship, Fannie Mae and Freddie Mac have signed contracts to issue new senior preferred stock to the Treasury, which has agreed to purchase up to $100 billion of this stock from each of them. If necessary, the Treasury agreed to contribute cash in the amount equal to the difference between each company's liabilities and assets. Each company issued the Treasury $1 billion of senior preferred stock and warrants (options) to purchase common stock for which the Treasury did not compensate the company. If the warrants are exercised, Treasury would own 79.9% of each company. Treasury agreed to make open market purchases of Fannie Mae and Freddie Mac mortgage-backed securities (MBS). Treasury has said that it expects to profit from the spread between the interest rate that it pays to borrow money through bonds and the mortgage payments on the MBS. Fannie Mae and Freddie Mac will guarantee payment of the MBS. Treasury agreed that if the companies have difficulty borrowing money, which has apparently not been the case to date, Treasury will create a Government Sponsored Enterprise Credit Facility to provide liquidity to them, secured by MBS pledged as collateral. There are no specific limits to these purchases or loans, but they are subject to the statutory limit on the federal government's debt. The authority for both preferred stock purchase and the credit facility will terminate December 31, 2009. At this point, there has been no announcement that the credit facility has been accessed, nor that any purchase of preferred stock has occurred.

Bear Stearns

On March 16, JPMorgan Chase agreed to acquire the investment bank Bear Stearns. As part of the agreement, the Fed lent $28.82 billion to a Delaware limited liability corporation (LLC) that it created to purchase financial securities from Bear Stearns. These securities are largely mortgage-related assets. The interest and principal will be repaid to the Fed by the LLC using the funds raised by the sale of the assets. The Fed's loan will be made at an interest rate set equal to the discount rate (2.5% when the terms were announced, but fluctuating over time) for a term of 10 years, renewable by the Fed.[6] In addition, JPMorgan Chase extended a $1.15 billion loan to the LLC that will have an interest rate 4.5 percentage points above the discount rate. Thus, in order for the principal and interest to be paid off, the assets will need to appreciate enough or generate enough income so that the rate of return on the assets exceeds the weighted interest rate on the loans (plus the operating costs of the LLC). The interest on the loan will be repaid out of the asset sales, not by JPMorgan Chase.

Any difference between the proceeds and the amount of the loans is profit or loss for the Fed, not JPMorgan Chase. Because JPMorgan Chase's $1.15 billion loan was subordinate to the Fed's $28.8 billion loan, if there are losses on the $29.95 billion assets, the first $1.15 billion of losses will be borne, in effect, by JPMorgan Chase, however. Thus, if the assets appreciate in value by more than operating expenses, the Fed will make a profit on the loan. If the assets decline in value by less than $1.15 billion, the Fed will not suffer any loss on the loan.[7] Any losses beyond $1.15 billion will be borne by the Fed. It will likely be many years until all the assets are liquidated, and a final tally of the Fed's profit or loss can be calculated.

Table 1. Summary of Current and Historical Financial Interventions by the Federal Government

Beneficiary	Action	Financial Commitment	Final Cost to Treasury
AIG (September 16, 2008)	Two-Year Secured Loan from the Federal Reserve	Up to $85 billion	Unknown (Government receives interest on loan plus stock warrants on up to 79.9% of AIG's equity.)
Fannie Mae and Freddie Mac (September 7, 2008)	Senior Preferred Stock Purchase	Initial commitment, $100 billion each; ultimately, no set limit	Unknown (Treasury receives $1 billion (each) of preferred stock and 10% accrual on the stock.)
	Purchase of Mortgage-Backed Securities issued by the companies	No set limit	Unknown (Treasury receives interest on any MBS purchased and may sell the securities in the future.)
	Credit Facility	No set limit; collateralized	Unknown (Treasury receives interest on any loans taken.)
Bear Stearns (March 14, 2008)	Asset Purchase through LLC controlled by the Federal Reserve	$28.8 billion	Unknown (The Federal Reserve LLC received $29.95 billion in relatively illiquid assets.)
U.S. Airlines P.L. 107-42 (September 22, 2001)	Loan Guarantees	Up to $10 billion	None except implicit value of loan guarantees; under $2 billion in loans made.
Savings and Loan Failures P.L. 101-73 (August 9, 1989)	Savings and Loan Failures and Insolvency of Federal Savings and Loan Insurance Corporation	Full faith and credit backing of Federal Savings and Loan Insurance Corporation	$150 billion.
Chrysler Loan Guarantee P.L. 96-185 (January 7, 1980)	Loan Guarantees	$1.5 billion	$311 million profit from sale of warrants.
New York City P.L. 95-339 (August 9, 1978)	Loan Guarantees	$1.65 billion in guaranteed bonds	None, except the implicit value of loan guarantee.
New York City P.L. 94-143 (December 9, 1975)	Short-Term Loans	$2.3 billion	None, except the implicit cost of the risk of loan.
Penn Central P.L. 93-236 (January 2, 1974)	Loan Guarantees in the wake of Railroad Bankruptcy	$125 million loan guarantees; $7 billion in federal operating subsidies	$3 billion net loss after sale of ownership stake and the implicit value of loan guarantee.
Lockheed P.L. 92-70 (August 9, 1971)	Loan Guarantees	$250 million of loans guaranteed for five years with three year renewal; guarantee and commitment fees charged	$31 million profit from sale of warrants less the lost value of loan guarantee.

ENDNOTES

[1] 12 U.S.C. Sec. 343.

[2] For more information on the Federal Reserve's actions, please see CRS Report RL34437, Financial Turmoil: Federal Reserve Policy Responses, by Marc Labonte. 3 P.L. 110-289, Title I.

[4] See Federal Reserve Statistical Release, H.4.1, dated September 18, 2008, available at *http://www.federalreserve.gov/releases/h41/Current.*

[5] For more information see the September 7, 2008 statement by Treasury Secretary Henry Paulson at *http://ustreas.gov/press/releases/hp1129.htm* and CRS Report RL34661, Fannie Mae's and Freddie Mac's Financial Problems: Frequently Asked Questions, by N. Eric Weiss.

[6] Federal Reserve Bank of New York, "Summary of Terms and Conditions Regarding the JP Morgan Chase Facility," press release, March 24, 2008.

[7] It will only have forgone interest it could have earned on other investments, namely U.S. Treasury securities.

Dr. Orszag, I noted in my opening statement that, broadly speaking, there are two conventions for booking assets like this. One is to treat it as the purchase of an asset. But oddly enough, when you do that the asset acquisition price of a payment is booked as an outlay, but the value of the asset itself, the corresponding value of the asset, is not entered anywhere on the Federal books until the asset is sold. At that time, the proceeds of the sale are treated as offsetting receipts or as a negative outlay.

The other is the Credit Reform Act in which case you try to calculate the likely losses and subsidies downstream and discount them back to present value. To the extent the present value is less than the original amount of the loan, you have got losses booked in the year of the loan.

Which does CBO prefer to undertake in this case?

Mr. ORSZAG. The latter. And in particular it is CBO's view that the budgetary treatment, if we went out and we bought in a liquid financial market where you would imagine that the Federal Government would be obtaining a fair price for an asset, we go out and we buy an asset for a dollar in a liquid market, the best budgetary treatment of that is basically that there is zero net gain or net loss at that point because you have purchased something for a dollar that is worth a dollar.

And what has happened is that the government has rearranged its portfolio, rather than caused a deterioration in its fiscal condition. That is much different than going out and buying a tank for a dollar, if you could buy a tank for a dollar.

So what we think is the best way of measuring these kinds of financial transactions is the degree to which what you are purchasing doesn't reflect liquid markets or doesn't reflect a competitive bidding process, and it is the net subsidy that you are providing. So if you go out and you buy something from a financial institution for a dollar that by some fair-value accounting basis is only worth 50 cents, the government should show a 50-cent subsidy. And the reason is that is what causes the deterioration in the government's physical condition. It is the subsidization that causes the deterioration, not just swapping assets on a fair-market basis.

Chairman SPRATT. That would be the amount that would be added to the deficit in that year?

Mr. ORSZAG. Under the proposed accounting treatment and under what we think is the best way to account for these transactions, yes.

Chairman SPRATT. So in all likelihood it would be substantially less than the requested amount, $700 billion?

Mr. ORSZAG. One would imagine that it should be substantially less than $700 billion, the net cost, yes.

Chairman SPRATT. Now, on page 3 of your testimony you say, At this time, given the lack of specificity regarding how the program would be implemented and even what asset classes would be purchased, CBO cannot provide a meaningful estimate of the ultimate net cost of the administration's proposal. The Secretary would have the authority to purchase virtually any asset at any price and sell at any future date. Lack of specificity, of course, makes it difficult for you to do anything.

However, on the next page you say, CBO expects the Treasury will probably fully use its $700 billion authority, but the net cash disbursements under the program will be substantially less than $700 billion. Would you explain that?

Mr. ORSZAG. Sure. It just returns to the discussion we were just having that the net impact on the Federal Government presumably will be significantly less than $700 billion unless you lose 100 percent of the value of whatever you are purchasing.

So I can't quantify what the net gain or loss would be without knowing whether the Federal Government is purchasing whole loans or tranche-by-tranche reverse auctions on mortgage-backed securities or more esoteric products. But it would seem implausible that the Federal Government would lose 100 cents on the dollar for every purchase that it made, which is what justified the statement on page 4.

Chairman SPRATT. Do you know and can you explain to us what scoring approach OMB intends to take?

Mr. ORSZAG. My understanding is that OMB intends to undertake—and the legislation reflects—a similar scoring process in which, while the methodology may differ slightly, the result is the same. Which is to say the cost that is shown on the Federal budget will be the degree to which the Federal Government subsidizes the purchase of particular assets.

Chairman SPRATT. Would the estimate of credit cost vary from transaction to transaction depending on the terms of the transaction?

Mr. ORSZAG. I would think so, yes.

Again, returning to the basic point, if the Federal Government said, even through an auction process we are going to go out and buy specific loans from different banks, it is much more likely the Federal Government will suffer some losses on those transactions, not only because you are likely to wind up with, even with any given FICO score or any given risk classification, the sort of worst part of the distribution of the asset classes, as financial institutions are selling you the stuff that they most want to unload; but also because, as various parts of the legislation now reflect, the Federal Government may well be a more lenient owner of that mortgage than the bank itself was in terms of foreclosing and other measures.

Chairman SPRATT. You give us a graphic description and a good description of what has happened in the illiquid credit markets. Can you give us your analytical view of what could happen if we don't provide some substantial and extraordinary assistance?

Mr. ORSZAG. Let me back up. Being able to obtain credit is crucial for households and it is crucial for firms. Our entire economy functions because people are able to obtain financing for what they want to purchase, and for firms what they—you know, new plans and equipment and investments that they want to make. And if that system collapses, we will have severe turmoil in the real economy, which is to say in our real lives in terms of our jobs, our output and what have you.

So that is the fundamental problem. We have already seen some ominous signs emanating from capital markets. Corporate debt issuance plummeted in the third quarter. The short-term asset-backed commercial paper markets are under severe stress; bank lending. It is implausible to me, given the tensions in the banking sector, that even though bank lending so far has held up fairly well that it will not also come under severe stress. So the various places where you can go for liquidity are drying up and that is a huge problem to the economy.

Chairman SPRATT. Dr. Orszag, thank you very much. We will turn now to Mr. Ryan.

Mr. RYAN. Let me just pick up where the Chairman left off because that is the kind of questioning I want to go to as well. Using the Credit Reform Act scoring methodology, but looking at this bill, Treasury is going to basically determine how to set up these auctions. And since we don't really have a price discovery mechanism right now, because we don't have a market for these securities, given that these mortgage-backed securities are—no one mortgage-backed security is like the other, you are going to have to give us a rear-view mirror score on this, correct?

I mean, typically when we pass bills here, you give us an estimate on what it is going to cost, and that factors into our budget and therefore we make decisions based on these cost estimates. Is it basically not the case here that if this passes and we give the Treasury the authority, then they go forward, set up these auctions, a price discovery mechanism, and based on the price they pay for these securities, then the subsidies determine—you are not going to be able to give us a true cost of this until after these trades occur; is that not correct.

Mr. ORSZAG. Well, yes and no. I think we could provide more information to you and at least an estimate of what the subsidies are likely to be if we knew even before the trades occurred what the structure of the mechanism was and what the asset classes are. So in particular if the Treasury said we are going to only do, again, tranche-by-tranche——

Mr. RYAN. Triple A versus mezzanine versus all this other stuff.

Mr. ORSZAG. Well, and even beyond that. They are talking about hundreds of thousands, if not millions, of mini-auctions. So it is not that we are going to go out and buy triple A-rated paper, sell us what you want, and we will determine a price; it is on mortgage-backed security number 123753 which is then—a tranche of that is then owned by 50 or 100 institutions. We are going to go out and bid just on that tranche, and you 50 or 100 institutions, you bid for us. We are going to buy 20 percent of the total. That is likely to obtain a fair price. So if that is all that we were doing, I would say a fair guess is zero.

If we are going out and we are buying, again just to return to the example of individual loans from banks, what we would provide to you then is some analysis up front before we knew what the individual transactions are of—if they say we are going to conduct auctions for FICO scores with the following ranges, we would look at what the distribution of performance of loans for those given FICO ranges are, assume the Federal Government is going to wind up with tilting towards the bad end of that distribution, given incentives for financial institutions, and give you some estimate based on that.

So in other words, if they went out and they said we are going to put $200 billion into reverse auctions on a CUSIP-by-CUSIP basis on mortgage-backed securities, $150 billion into purchasing individual loans in the following way and what have you, we could at least give you some estimate of what the net subsidy would be across those different asset classes. But we don't even know that.

Mr. RYAN. So once the methodology is determined by Treasury, then you can start giving us estimates.

Mr. ORSZAG. Yes.

Mr. RYAN. Treasury, they have a couple of concerns, meaning they want to pump liquidity into these firms, into these banks, and they want to get these bad assets off the books. And we don't want the taxpayer to have to pay for it. We want this to be a net zero cost here. We are kind of at odds here, are we not?

Mr. ORSZAG. Yeah.

Mr. RYAN. And if the goal here is to pump liquidity into these institutions, that means they are not intending to pay fire-sale prices for these securities. They are going to pay above fire-sale prices. If the goal is liquidity, that means the taxpayer is going to pay for some of this; is that not correct?

Mr. ORSZAG. I think we need to be very clear about what we are trying to accomplish here because the descriptions about what the programs are trying to accomplish often do get muddled. And as I mentioned before, there are two problems. One is many financial institutions may be insolvent and we are concerned about that. The second problem is various financial markets like I showed on my graph are not functioning effectively. Solving that second problem need not involve any significant subsidy from the Federal Government; solving the first problem does.

To the extent that we implement these programs in a way where we overpay for assets, we are sort of in a backhand way addressing the insolvency issue, even though the program is framed as addressing illiquidity. And I would go beyond that and say we are likely to be addressing the insolvency issue in a kind of haphazard way where we are providing support to particular financial institutions that may not be under stress, not providing support to others that may be under stress. And if we are going to address the insolvency issue, it may be better to do it directly.

I would also note, by the way, one other thing. That restoring liquidity to particular financial markets may actually exacerbate insolvency concerns because there is lack of clarity right now about which institutions are or are not insolvent, in part because many financial institutions are not fully marking to market. They are using flexibility not to fully mark their assets to market.

Mr. RYAN. To play it out longer.

Mr. ORSZAG. To play it out longer. And that is also creating some illiquidity because they don't want to sell at current market prices, given that that would then require them to book the losses and perhaps trigger problems.

If we establish pricing for these assets, many institutions may be revealed to be insolvent because they would then have to mark to market, given the rules, which may look like a bad thing because the number of insolvencies would go up; but then again, I would say to the extent you have these sort of hidden insolvencies throughout the financial system, one of the reasons that trust in the financial markets is now undermined is precisely that concern. So if we revealed which institutions did and didn't have problems, even if that caused some insolvencies to be revealed, the net result may be positive in terms of restoring confidence that the people you are dealing with actually are solvent.

Mr. RYAN. So when we establish price discovery, that is going to occur. If we subsidize the price discovery, we are going to delay the inevitable insolvencies that just have to get flushed through our system.

Mr. ORSZAG. Well, if you subsidize the asset purchases, you are doing two things. You are sort of establishing some more price transparency, but you are also then transferring resources from taxpayers to particular financial institutions in a way that may be haphazard.

Mr. RYAN. So if the goal here is solvency, is capital injections, it is a pretty crude tool we are using here and we may not be giving them to the healthiest organizations or institutions that ought to get the capital injections, and that is basically what you are saying. If the goal here is a liquidity issue, that is one thing. If it is a solvency issue, this is not the way to go about doing it correctly.

Mr. ORSZAG. Well, just to return, I would say if it is a liquidity issue, then one should focus on trying to get the best price possible for the Federal Government and avoid overpaying. And to the extent it is a solvency issue and you are addressing that by overpaying for particular assets, you are kind of scattering money across lots of financial institutions, some of which may be perfectly healthy and not need help from a solvency perspective, and you are overpaying them too.

Mr. RYAN. And we will simply delay inevitable bankruptcies.

I will just finish with this. Let me ask you your professional judgment. And you are a trained economist. Do you see our problem primarily as a liquidity problem or as a solvency problem, meaning—and I think we just went through this a bit—do financial institutions suffer from a lack of short-term funding or have their assets declined to such an extent that they need to be recapitalized? What do you think is in essence the primary problem here?

Mr. ORSZAG. I think both problems.

Mr. RYAN. So you think they are twin?

Mr. ORSZAG. I think both markets are affecting financial markets, yes.

Mr. RYAN. All right. Thank you.

Chairman SPRATT. Ms. DeLauro.

Ms. DELAURO. Thank you, Mr. Chairman.

Dr. Orszag, thank you. I know that this is the Budget Committee and the questions are technical with regard to the budget. I am trying to put myself in the shoes of middle-class Americans who are trying to understand in essence what is happening. And, quite frankly, there hasn't been any real explanation to middle-class Americans about what is happening to this Nation.

And reverse auctions and liquidity and insolvency and short selling and naked shorts and all that, they have no understanding. They just know that they are already in a very severe economic crisis and real economic insecurity in their families. And what is all of this going to mean to them?

You started to say—and I would like you to address this, because you said something in your commentary that said that credit is stability, in essence is what you said. If you can describe what this financial situation at this moment, in the absence of whatever program they potentially would be looking at in terms of trying to bring some sense out of insanity here, how would you describe this to middle-class America and saying this is where we are, this is what this means to you, this is what happens if we do not act? And what are the kinds of pieces that need to be put into place in order to safeguard your economic security in this morass?

Mr. ORSZAG. And I am going to try to avoid using any big words in doing this.

Ms. DELAURO. Thank you.

Mr. ORSZAG. Financial markets——

Mr. BLUMENAUER. Speak slowly.

Mr. ORSZAG. I will speak slowly and not use big words. Financial markets—that is, banks and the institutions that lend to—let's just take a hypothetical household. They work for a company, Company X, Y, Z. They own a house, they own some cars, okay. The company that they work for finances its operations. So it makes whatever, widgets or whatever you want it to make. And it relies on borrowing from lots of financial markets and from banks in order to do what it does.

Right now financial markets are suffering a collapse of confidence. The people that—the institutions that would normally lend to your employer are reluctant to do so, in part because of this turmoil surrounding, again, lack of confidence. And the company itself would often sometimes issue debt to finance its operations. It would issue a bond or something like that so that it could have cash to pay your salary. That is also under stress. It would borrow over, like, for short periods of time and then pay the money back.

So let's say it had a new set of inventory coming in. It would borrow a little bit of money to buy the inventory and then as it sold this stuff at stores, it would pay off that short-term loan. It is having trouble getting that, too, because of this collapse of confidence.

Similarly, ultimately the bank from which you got your mortgage and the bank that financed your auto purchase, they are under stress, too. They don't have enough capital to lend you that money. And that is in part because they are having trouble borrowing from other banks and other financial institutions.

So this implosion of confidence among financial market participants ultimately will affect you, even though right now it may seem really esoteric and kind of just out there in some other world. It will come home in the form of your company having trouble financing its operations, and it will come home in the interest rates that you have to pay on mortgages and auto loans and what have you, and those effects may be somewhat delayed. The history does suggest that those kinds of effects occur some period after the financial market turmoil itself begins, but they do happen.

Ms. DELAURO. Quickly, let me ask you this. One of the main causes of this was the subprime mortgage crisis, if you will, the whole issue of how mortgages were issued et cetera. If that being the case, with all of the potential relief that we are trying to bring to the markets here, in anything that you see, with any of the current plans that are on the table, the conditionalities, et cetera, is there anything that is essentially looking at restructuring, if you will, our mortgage institutions fundamentally and in the way they do business and the mortgage contract?

Do you see any of that in anything that we are looking at, if that was the root cause of this problem?

Mr. ORSZAG. I would go broader and say we are in the middle of a potential crisis and there are a variety of things that seem targeted at that, although with some ambiguity about exactly what they are targeting, as we were just discussing.

And then, secondly, there are a whole series of structural and regulatory reforms, not only on home mortgages and commercial mortgages, but in terms of the overall regulation of the financial sector, that are under discussion and that are worthy of serious consideration.

I don't see them moving at the same speed as this proposal appears to be.

Ms. DELAURO. On what side? Where's the speed? On the financial institutions versus the mortgage side, or is it a regulatory problem?

Mr. ORSZAG. No, no. I just meant the whole question of how to structure the regulatory apparatus, which I want to say is in need of restructuring, but one also needs to be very careful. We often fight the last war and create the seeds of the next problem by making changes that seem attractive at the time, but then create problematic incentives later on.

So as we move forward in restructuring financial regulation, including for mortgage originators and the whole mortgage process, one needs to be very careful to make sure we are not just fighting the last war but also looking forward to preventing the next one.

Ms. DELAURO. I just will get you a copy of an article in the New York Times, September 21st, by Robert Shiller at Yale, the professor of economics at Yale, talking about the mortgage of the future and some ideas about how to restructure. And I would like to get your views on that.

Mr. ORSZAG. Let me just briefly pause. This is a little bit outside of the immediate hearing. But Bob Shiller and others are emphasizing something that I think is crucially important: that in financial markets and in the rest of public policy, we need to be paying more attention to psychology and a little less attention to the purely rational econ 101 version of the world where everything is frictionless and things work perfectly. Because in the real world that often tends to be particularly important. And Bob Shiller is among the leaders in advancing that field of thought.

Ms. DELAURO. And he talks about continuous work-out mortgages and us investing. Thank you very much, Mr. Chairman, I appreciate your bearing with me.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. And thank you for calling this hearing. It is clearly one of the most important hearings I have attended in my congressional career. For many of us, I think, we feel like we are being faced with a financial panic and crisis on the one hand and potential taxpayer bankruptcy in a fundamental change in the role of government in a free enterprise economy on the other.

For those who may think that Congress will choose between those two options in 72 hours, that is a rather naive thought. So I appreciate, Mr. Chairman, you holding this hearing.

I think I understand the short-term gain to be had by the Paulson plan or some permutation thereof. But clearly this committee also needs to focus on potential long-term pain, long-term pain to the taxpayer.

Although we reviewed it before Dr. Orszag, simply the Federal Government that we have today left on automatic pilot, isn't it more or less the consensus of CBO, OMB, GAO, that without any fundamental changes in the programs we have today, that if we wanted to balance the budget through tax increases only, that we would essentially have to double taxes on the next generation? Is that not the glide path that we are essentially on?

Mr. ORSZAG. Very substantial increases in revenue would be required. We have substantial increases in spending driven, as you know, mostly by our health programs under current policy.

Mr. HENSARLING. So we are coming off, I believe, the single largest 1-year increase in the Federal debt, the single largest unfunded obligations we have ever had, at roughly $57 trillion, and the long-term prospect is not good today. So on top of that, we are looking at perhaps a $700 billion program.

Some say, and I believe you opine, that maybe there is a possibility the taxpayer actually made money out of this. But first let's look at history as our guide. And you have greater expertise on this than I do. But the closest incident I can find is the S&L bailout of the early 1980s. My reading, in real dollars, is that cost the taxpayer roughly $150 billion to $200 billion. Do you have a different reading of that?

Mr. ORSZAG. That is roughly the same range. I agree with that range.

Mr. HENSARLING. So it is certainly not axiomatic that somehow the taxpayer is going to make money if they buy a bunch of troubled assets. There is certainly the potential for great loss.

Mr. ORSZAG. But let me just clarify. And there have been parallels drawn to the Resolution Trust Corporation and what have you. It is a much different situation. That loss occurred mostly because the Federal Government had insured deposits at institutions that then failed. And the assets, the Resolution Trust Corporation, the asset part of that was when the institution failed, we took over the asset side of their balance sheet in addition to the liabilities, and then we sold off the assets. That is a much different thing than going out and buying assets, seeing what price you can get for them, and then later selling them.

Mr. HENSARLING. But they are still illiquid assets in many places without a functioning market.

Let me also ask you this question. There is certainly a cost in allowing financial institutions to fail. And as you well point out, there is a huge psychological component to the capital markets. But isn't there also a cost to keeping some institutions open that perhaps should be forced to realize their losses?

Is there a parallel to the lost decade in Japan where essentially by trying to keep failed financial institutions open, they enjoyed a decade of stagflation and negative economic growth? Might that be a potential cost to this plan?

Mr. ORSZAG. Yes. In particular, perpetuating—so I think the lesson of history suggests that especially in banking crises, that perpetuating insolvent institutions just raises costs. And it is better to address the problem up front, take the problem assets off the books somehow, or address the problem directly. And I think the Treasury folks would say they are trying to do that.

Mr. HENSARLING. In looking—a number of Members of Congress, Dr. Orszag, as you probably know, are looking at a lot of options. And clearly there are many lousy options on the table, and to some extent it is having to choose among lousy options. Some wish to explore a secured loan program versus Uncle Sam walking in to try to buy up troubled assets from institutions that may not deserve it and may not deserve—and may pose longer term systemic risk to the economy by staying open.

How would, under CBO scoring—and maybe the answer is the same—are we essentially trading asset for asset if conceptually the program was structured as a secured loan program as opposed to an asset purchase program?

Mr. ORSZAG. I have heard some discussion of similar proposals, and the scoring would be the same. The question is—so you are extending a loan secured by some underlying asset to a financial institution or someone else—and the question is what are the loan terms and are you subsidizing that facility or not? And if you are not, the net cost in expected value is zero.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Edwards.

Mr. EDWARDS. Dr. Orszag, I will leave the debate for another day on how we got into this mess and to what extent unpaid for tax cuts and the deregulatory philosophy were major contributors to all of this. And I think we all recognize we are facing a serious crisis.

My first question to you is, is this potential crisis so severe and so imminent that the difference between Congress acting by Friday of this week or Friday a week later could make a difference in the economy?

Mr. ORSZAG. I can't answer that. What I can say is that if there is no action taken and Congress departs and there is just nothing, that you are running a very substantial risk of utter financial crisis. Whether it has to happen over the next 72 hours or the next week or 10 days is impossible for me to say, and I don't think anyone can say.

It comes back to the role of confidence in psychology. That is at heart what we are dealing with here is the confidence of financial markets.

Mr. EDWARDS. Would it be your best judgment—and I realize it is subjective judgment—but would it be your best judgment if the congressional leaders, Republicans and Democrats alike, say we are going to have a rescue plan, it will be significant, but we are going to take an extra week to get it right, rather than to push it to the President's desk under a gun?

Mr. ORSZAG. Again, my perception is the key thing that financial markets are looking for now is the existence of a significant package. And I suppose that coming out with a statement of principles or agreement that there will be a package, and that we are going to make sure that we reach agreement on that within some period of time, would fulfill that purpose.

Mr. EDWARDS. My next question is, what would be your expected projection on the impact on short-term or long-term interest rates when the United States Government goes out in the markets and borrows $700 billion?

Mr. ORSZAG. That is a great question. It depends on the degree to which—two things—the degree to which we actually wind up subsidizing things; and, secondly, the degree to which the financial markets perceptions and psychology matter.

So let me just in a purely rational, you know—everything works like a textbook suggests—any effect on interest rates and the exchange rates should only reflect the degree to which the Nation's underlying fiscal condition is deteriorated as a result of these interventions. And again, if we are getting a fair price and there is no net subsidy, that is just a wash. That should be you are just trading one asset for another. It shouldn't cause any—at least in a purely textbook kind of rational way—shouldn't cause any financial market effect, including on interest rates.

But to the extent we do subsidize the purchases, that should show up in interest rates and the exchange rate; and, secondly, to the extent that financial markets don't have clarity about whether we are providing a subsidy or not and are guessing about that, there can also be effects on interest rates and exchange rates from that.

Mr. EDWARDS. Okay. My final question is this. Give me the best-case scenario, the worst-case scenario and what you think is the most likely scenario of Congress taking no action. And when I say "best case" and "worst case," I mean in terms of impact on GDP, I mean in terms of unemployment rates, I mean in length of a recession or potential depression, if you are talking about the worst-case scenario.

Mr. ORSZAG. You are asking me if Congress does not act what the effects would be?

Mr. EDWARDS. I am asking you if Congress takes no action—make that assumption—what is the worst-case scenario, what will happen to our economy in terms of GDP growth, in terms of unemployment rates, length of a recession or potential depression, and what would be the best-case scenario if Congress takes no action? And then if you still have time, what you think the most likely scenario would be.

Mr. ORSZAG. I will just come back to saying that if having created the expectation in financial markets that there will be a package, and given the stresses that we saw last week in financial markets, if there is no package whatsoever, there is a very significant risk of utter financial market chaos, which will then have significant effects on the real economy in a way that I think isn't particularly helpful for me to lay out in its full gory details. But it would be a very bad situation.

Mr. EDWARDS. Let me focus on that because I want to make it clear. I am talking about the worst-case scenario, not your most likely projection. But we need to understand in looking at the cost and benefits of taking action or no action, and one of the costs of taking no action is the worst-case scenario, is it possible that the worst-case scenario—if Congress takes no action—is something similar to the market crash of 1929?

Mr. ORSZAG. Again, I don't want to start speculating on the precise quantitative magnitudes other than to say you would, in that case I think, have a financial market meltdown which would cause very severe economic dislocations, which may be on the order of magnitude of Great Depression-type effects, but exactly how it plays out—one of the things about crises is they can play out in such a terribly diverse array of ways that speculating in exactly the specific way that a crisis plays out doesn't seem productive to me, other than to say it would be very serious.

Mr. EDWARDS. Thank you.

Chairman SPRATT. Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman. And I appreciate my good colleague from Texas not wanting to debate how we got here, because I too would like to defer that, and whether it goes back as far as the Community Reinvestment Act and the seeds of that causing it, we can have that debate at a different day.

You cut off your analysis of the family impacts. Talk to us a little bit about the impact that that reduction in business, slowdown for that particular business, would have on the family's 401(k) to the extent it might be invested in company stock and the impact that that had? And then also visit with us about the risks that this could severely damage the overall U.S. economy and kind of give us a magnitude.

We had a guy the other day give us kind of a back-of-the-envelope guess as to what Federal revenues might be impacted if we had a 1 percent increase in the economy or a 1 percent decrease in the economy.

So flesh out the impact on the family. In addition to jobs and those kinds of things, one of them said they were 401(k) and retirement planning.

Mr. ORSZAG. Well, again, to the extent that as the prices decline, their 401(k)s and IRAs and any other assets they have would decline also. To the extent that you are causing further disruption to the housing market and shutting down any additional mortgage lending or making that much more expensive, you are also curtailing or reducing their house price perhaps even further, raising difficulties for them to finance any new purchases, even if they would want to, given the threat to their employment and income because their employer is having difficulty.

So all of these things become a self-reinforcing negative spiral. And the fact that they are then less confident about their future and not going out and buying the new refrigerator means that the seller of the refrigerators has lower sales. That is the kind of scenario in which you can have a very substantial downward spiral that affects the macro economy.

You are then also right, if we were to enter a severe recession, Federal revenue would be significantly adversely affected. And in addition to that, various kinds of spending would go up, including things on food stamps and unemployment insurance and what have you, the net result of which would be to take the deficit figures that have already been spoken about and raise them significantly.

Mr. CONAWAY. Give your thoughts on, as I look at the circumstances, the most immediate issue to me is a seizing up or a freezing of this overnight credit market that is really below most people's radar screens.

I was in a bank and used to run the bank's long- and short-term portfolio, and all extra cash every night was invested and you just assumed it was coming back the next day. To me, that is the crisis of confidence and the risk to the system.

How does dealing with the housing, the subprime mortgages, and all these other kinds of things, fixing that, how do you see that instilling the confidence or restoring the confidence that these individuals across the United States who are making those overnight decisions will have that the money is going to come back the next day?

Mr. ORSZAG. They are related. Let me pause on this for a second, with the Chairman's indulgence, because I think this is crucial. This is what one of the most salient aspects of the crisis has been, which is, to a first approximation, financial institutions are no longer lending to each other on an overnight or short-term basis. Instead, it is being intermediated through the Treasury and the Fed. So instead of financial institution A that has extra money lending directly to financial institution B that needs the money for the day or for the night, the financial institution that has extra money is lending money to the Treasury, which is selling additional debt. The Treasury is taking the cash and putting it in the Federal Reserve. The Federal Reserve is taking that money and lending it out to financial institution B, because financial institution A is unwilling to extend the credit to the other financial institution, given the risk of not being repaid, whereas they are confident that the Treasury Department will repay—you know, is good for the money or that that will all work out well. And the Federal Reserve is willing to lend to financial institution B.

It is not a healthy development for the Federal Government to be intermediating overnight in short-term transactions in that way and to that degree, and that reflects the collapse of confidence.

So then the question becomes, what jump-starts that confidence again? And the two approaches, broadly speaking, are to restore liquidity to various asset classes that are currently illiquid. I am not lending to you because you have got $200 billion of mortgage-backed security stuff on your books, and I am not really sure what it is worth. So that is one way of approaching it.

The other is, I am not worried you have enough capital—even if I knew what the $200 billion was worth—that you have enough capital cushion, if housing prices and mortgage-backed security prices decline, that you would be able to repay me, given the difficulty you may have in raising capital yourself. So I want you to have a bigger capital cushion.

And that leads to the equity injection or more solvency prism or perspective on the problem. Either approach could help significantly, and in fact in some sense that is the driver of the crisis. Having that overnight lending collapse, as that chart showed you, is a very unhealthy development. And putting the Federal Government in the middle of all those transactions is not a salubrious way of running a financial system.

Mr. CONAWAY. As part of your telling us you weren't going to use long big words, "salubrious" is a big one. Thank you, Mr. Chairman, I yield back.

Chairman SPRATT. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman. Thank you, Dr. Orszag, for your very helpful testimony. I would like to divide the problem into three levels: Number one is fighting individual fires; number two, fire control policy of systemic solution; and number three, talking about the fire department. First, talk about fighting individual fires, financial fires. How much capacity does the Treasury Department or the Fed have to take on an individual case today like an AIG or a Lehman Brothers or a Bear Stearns?

Mr. ORSZAG. The Federal Government has substantial capacity to take those on. The question is whether that is the most efficient way of doing it. And the concern is that financial markets, without a more systematic approach, get concerned about a particular institution, AIG, and then we step in on that, and then they become concerned about some other institution, we have to step in there, and then it is like the whack-a-mole game where something keeps popping up and it is very difficult to keep up.

Mr. COOPER. I share those concerns, and I want an efficient solution. We are going to have a substantial debate over the efficient solution of fire control policy, so it is no longer just whack-a-mole. But your answer did seem to indicate that the Federal Government has still substantial capacity to take on the moles as they need to get whacked.

Mr. ORSZAG. At some cost to the American taxpayer and at some cost, ultimately, to our outstanding reputation with regard to our debt and risk characteristics. But, yes, we do have—we can issue a lot more Treasury debt if we need to.

Mr. COOPER. The second level, fire control policy. Your distinction between the liquidity problem and the insolvency problem is very helpful, and I wish that more discussion could take place on that. As I break that down, it seems like if the taxpayer invests in solving the liquidity problem, we have a substantial opportunity by buying assets at fire-sale prices to possibly even make money, because some bailouts in the past have in fact produced revenue to the taxpayer; for example, the Chrysler bailout when we got warrants.

But to the extent we try to bail out insolvent institutions, on the other hand, we can face a substantial risk of not only losing money but keeping debt institutions alive artificially that probably should be taken out in the market. So we face two different types of choices here that can conflict.

But my main question is on the integrity of the fire department. That is the Federal Government. If we lose the capacity to fight fires, then we are really in trouble. And that is my ultimate concern because, as was discussed earlier, the fiscal gap, the huge unbudgeted, untold liabilities of this country, are at least $57 trillion; and if you throw in Medicaid, it is probably $70 trillion or $80 trillion.

And we do know that when this administration went into office, the total national debt accumulated over 230 years was, like, $5 trillion. But now, with the latest administration request, that will be up to $11.3 trillion, greater than a doubling in just 8 years.

To some extent, I am worried that we could lose our capacity to fight fires. And that is the ultimate concern. And that is why Congressman Frank Wolf and I have proposed an entitlement reform commission, so that this Congress and future Congresses can get advice from experts on how best to tackle these gargantuan problems. Because I love Medicare, I love Medicaid, I love Social Security, I want to keep them alive, but the best way to keep them alive is to prepare for their needs.

Mr. ORSZAG. Let me say two things about that.

One, as this committee has heard over and over again, and I don't want to sound like the boy crying wolf, but it is a fact that, given the path that we are on, two things: One is we will ultimately wind up with a financial crisis that is substantially more severe that even what we are facing today if we don't alter the path of Federal spending; and secondly, that if we were on that path in the future and something like we are experiencing today occurred, we would have much less maneuvering room to fight those fires, because we will have already depleted the fire truck.

Mr. COOPER. Thank you, Mr. Chairman. My time has expired.

Chairman SPRATT. Thank you.

Mr. Garrett?

Mr. GARRETT. Thank you, Doctor. And let me, too, compliment your presentation. For an economist, you are extremely understandable. I appreciate that.

And just a couple points I would like to go over with you.

When I just walked in, I came in after your presentation, but one of the answers to Paul's question was how you put this on the books. And I thought I heard you say something to the effect of the dollar-for-dollar example, and I thought you made some sort of comment as far as the element of the fact that the Treasury, you don't know right now—A, you don't know the plan specifics, but, B, you don't know right now how long they are going to hold these assets; they may hold them for a day, a week, a month or a year.

The question is, does that element of uncertainty go to the issue? I don't think it does, but does it go to the uncertainty for you being able to come up with a figure on the balance sheet?

Mr. ORSZAG. We know basically nothing about how this program is going to be implemented with regard to even what assets will be purchased, how they will be purchased, how the structure of incentives for the asset managers that will be acting on behalf of the Federal Government will be structured.

So, in that context, what I said was, at this point, we can't give you a quantitative estimate because there aren't any details on which to base a quantitative estimate.

Mr. GARRETT. But the question, though, is, if you had most of the information, whether they sell them a day or 6 years later, shouldn't—if I understood you correctly, the dollar-for-dollar exchange, because whether you would sell them the next day or 6 years later——

Mr. ORSZAG. Yeah, that wouldn't be at the top of the list of characteristics that I would be looking for to evaluate the net subsidy.

Mr. GARRETT. Thank you.

On a broader issue but on the sale aspect, we have heard various things as to what their plan would be. I thought I heard Chairman Bernanke say in the Senate committee the other day that he would think probably what they would want to do is to hold the securities for their life, their duration, even though they may be 30-year notes or what have you. In reality, if they are home mortgages, most people move in 7 years, so they are probably going to hold them for 7 years.

Assume that is the case, that they hold them out, as opposed to the RTC arrangement, which, as you already discussed, is not as comparable but, in that case, it was more of a fire sale, "let's get rid of these things so we can move on." The fact that you would hold them out for that period of time would, A, I presume get you potentially a better price for them, but, B, does that affect the bottom-line impact that it has on the economy overall as potentially dragging out, if you will, the negative downward pressure on the economy over time? Is there an uncertainty of anybody else getting to that market?

Mr. ORSZAG. You know, I think there has been a lot of confusion about exactly what those remarks meant. It is not clear to me that they were intended to mean that the Federal Government would hold the asset to maturity, as opposed to perhaps drive pricing closer to the valuation that would be consistent with holding it to maturity.

But, again, I think there has been a lot of ambiguity about precisely what those comments did or did not mean.

Mr. GARRETT. Can you just give a hypothetical, though, does the impact, were the Feds to say, "This is our policy, to hold them out," how does that impact upon the economy recovering during that period of time?

Mr. ORSZAG. Again, I would go back to it is not actually whether the Federal Government holds it to maturity, because that goes back to the length of—whether you are selling something tomorrow or next year or 2 years later. Primarily, I think a more important aspect of this is, are you trying to reveal what market pricing is today, or are you trying to come up with some concept of what you think that underlying value on a hold-to-maturity basis is, which, if you are not doing it through a competitive process, could wind up being very complicated and could wind up having the Federal Government pay substantially more than current market pricing suggests.

Mr. GARRETT. Okay. The proposal that you have been talking about today, the general proposal, the major bailout, one comment is budgetary treatment of the proposal. But could you go back a little bit to one of the last sections that we did, and we talked about this, and that is the GSE situation, and just give your comment on—not the dollar figure, I am not trying to put a dollar figure on it, but whether or not and how it should be budgeted?

Mr. ORSZAG. CBO has suggested that, given that these entities are no longer plausibly arm's length from the Federal Government, in our view, their operation should be combined with the Federal Government's operations in the budget. And that is the way we are going to be reflecting their activities in our baseline early next year.

And, by the way, a recent development, I think, underscores the wisdom of that approach, which is, I believe it was last week, the Secretary of the Treasury said, "We, the Treasury, are going to go out and purchase additional mortgage-backed securities, and we are also directing Fannie Mae and Freddie Mac to do the same thing."

I don't think that those two things should be reflected differently in the Federal budget given that they are based on the sovereign power of the Federal Government in terms of ultimate direction. And our approach will reflect those in similar ways.

Mr. GARRETT. So is that potentially like a $6 trillion or $7 trillion item that you add to the budget or——

Mr. ORSZAG. Exactly how it is done is a little bit complicated, and it is unlikely to be anything close to those numbers.

Mr. GARRETT. I would be curious sometime just to——

Mr. ORSZAG. Sure.

Chairman SPRATT. Mr. Becerra?

Mr. BECERRA. Dr. Orszag, thank you very much, once again, for your testimony.

Let me move back for a moment. For many years, we have been concerned about the size of the budget deficits that the Bush administration has been running. The Bush administration came in in 2001. We were told that there would be budget surpluses totaling something close to $6 trillion, about $5.6 trillion, over the next 10 years. And, instead, we have seen nothing but deficits, record deficits, over the last several years, to the point where we have seen over $3.5 trillion in deficit spending under this administration, some $3.5 trillion added to the national debt, if that is about right?

Mr. ORSZAG. I don't have the number off the top of my head.

Mr. BECERRA. It is something over $3 trillion.

Mr. ORSZAG. I will take your word for it.

Mr. BECERRA. If we didn't have a deficit of over $400 billion that we are looking at for this coming fiscal year, and had we not spent hundreds of billions of dollars each year over what we had over the last 7 years of the Bush presidency, would we be in better shape as a Nation to try to help address this financial mess that we are confronting today?

Mr. ORSZAG. I would say that the lower the public debt is relative to the size of the economy and the smaller the budget deficit is as you go into a crisis, the better off you are in terms of dealing with a crisis.

Mr. BECERRA. It sounds like an economist's way of saying "yes."

Mr. ORSZAG. Yes, it is.

Mr. BECERRA. Now, part of that massive debt that we have incurred over the last 7 years went to help pay for the President's tax cuts, the Bush tax cuts of 2001 and 2003. We were told that these tax cuts would help provide economic growth and increase prosperity for Americans. And today what we know is that deficit spending to cover the costs of those tax cuts has left this country in a more difficult predicament, as we just indicated from the previous question about the size of the national debts and how it leaves us now in a more difficult posture to try to deal with this financial crisis.

After 7 years of the 10-year Bush tax cuts, do you see any near-term positive outlook for the economy?

Mr. ORSZAG. Well, CBO, even before this most recent collapse of confidence in the financial markets, issued an economic and budget outlook in which we projected very significant weakness in the economy for the rest of this year and into the early part of next year, and then, thereafter, some recovery back to normal conditions. If anything, the financial market turmoil should only make that outlook somewhat more dire.

Mr. BECERRA. Yeah. So, even now, close to the end of the 10-year Bush tax cuts, we still haven't seen that rosy garden that we were supposed to find after devoting trillions of dollars to these Bush tax cuts that went mostly to very wealthy folks, many of the same folks who probably got us into this mess that we are in right now in the financial markets.

Middle-class American families are doing today what they did yesterday, what they did 3 years ago, and they are probably going to continue doing the same thing a year or 2 years or more from now. That is, they get up in the morning, they go to work, they send their kids to school, they try to save a little money. Most working-class Americans, whether they are in the middle class or not, are doing the same thing they did before, they did today, and they will do tomorrow.

Now, lenders in this country aren't doing what they did yesterday, may not be able to do the same thing tomorrow. Many of the traders on Wall Street aren't doing what they did yesterday, are doing things differently today, and may do things differently tomorrow.

But it is the guys on Main Street, that middle-class family, that working-class family, is the one that is being asked to do something differently, even though they kept doing the same thing they did year-in, year-out: work hard and provide for their family.

Is there a quick way that you can explain why that family that didn't do anything that he or she or that family knows about to cause this financial mess should now, all of a sudden, be asked to give dumb money, in other words, to have no say? They are the Mikeys in this mess, if you can remember the commercials 20 years ago. The brothers would always give the littlest brother, Mikey, the new cereal that——

Mr. ORSZAG. Mikey likes it, yes.

Mr. BECERRA. I don't know if Mikey would like this one.

But is there any reason why we should treat the American middle class as Mikey without knowing what we are going to get in coming up with any $700 billion bailout?

Mr. ORSZAG. Well, again, I think those kinds of questions are really for you rather than for me. But I would come back to saying that, even if it is not any of their doing, that family ultimately, if we perpetuated this kind of financial market turmoil, will be hit in some unfortunate way, even if it is not their fault or has no direct connection between what they were doing and the current turmoil. That is unfortunately the case.

Mr. BECERRA. So, unlike the Bush tax cuts that went principally to very wealthy folks, not to middle class; unlike the unpaid-for expenditures in Iraq, which probably gave America's families, in many cases, a smaller family because of the death of a soldier; perhaps, in this case, we could try to ensure that if the American family is going to be asked to bail out people that they don't deal with on a day-to-day basis, that we make sure it is an investment for the American family.

So if we are going to give any amount of taxpayer money, we have to make sure there is a return for the American taxpayer before we move forward. And, certainly, at this stage, we haven't seen the administration come up with a proposal that does that for the American family.

And you don't need to comment. That is more a rhetorical question. But I thank you for your time here.

And, Mr. Chairman, I yield back the balance of my time.

Chairman SPRATT. Mr. Porter?

Mr. PORTER. Thank you, Mr. Chairman.

And, Doctor, I appreciate working with you the last 2 years. We appreciate your professionalism, and it has been truly a pleasure to work with you, so thank you very much.

I will probably be less kind to the administration than even some of my colleagues here this morning. But, first, this is actually more of a comment than a question.

I think you know that in the great State of Nevada we have one of the highest foreclosure rates in the country; in my district, about one out of 45 homes. It is a tragedy that is happening. Plus, add to that the lack of an energy policy for our country has caused great economic hardship for our community of Nevada, the resort industry. Visitation is down; we are laying off employees. So not only in Nevada is the price at the pump a problem of getting to work, it is also preventing people from coming to visit our community.

But I tell you that there are families that are hurting. And what Wall Street has done is morally reprehensible. And it appears to me that in Las Vegas we have more regulations and enforcement than we have had on Wall Street. I am appalled that we have a crisis of this magnitude, that has risen to this level, without oversight and without the proper enforcement. And, again, this is more of a comment, Doctor, because you are here to try to help us find a solution; I am here to talk about the problem for a moment.

I think the administration should have known about it, and I think they should have known sooner. If they didn't know about it, that is even a bigger problem. But I am extremely troubled that Congress now, in the final hours of a session, is having to find solutions to a problem that didn't just happen overnight.

I think we are going to see, Mr. Chairman, a lot of possible solutions that are presented. And I am convinced that we need to take some pretty decisive action and do it as quickly as possible.

But I want to make sure that there aren't individuals somewhere sitting on a yacht, eating shrimp and drinking champagne, that have taken advantage of the American people. And I know that it is troubling. The overall majority of the calls I receive from my district are opposed to a bailout. But we have to, of course, look at the ramifications you presented this morning.

So I want to say thank you for your diligence, Doctor. I, again, share my frustration, anger with what Wall Street has done and what I think the administration should have seen coming. In fact, a year ago, when we were looking at the mortgage crisis as it was escalating, we should have taken a timeout and looked at the ramifications.

As my friends have mentioned, you know, the fire department, I think that Wall Street, I think the SEC, I think the administration, and even many Members of Congress have not taken the steps that they needed to take to prevent this from happening.

So, again, that is not a question, Doctor. I appreciate you being here and being part of the solution. Thank you.

Mr. ORSZAG. Actually, if I could just take this opportunity, since there were compliments about the testimony, to compliment the CBO staff that has been doing a fantastic job under trying conditions.

Chairman SPRATT. Thanks very much.

Mr. Blumenauer?

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Frustrating, because we have had some conversations in this hearing room about this slow-motion train wreck that has been occurring for years now, dealing with a subprime mortgage market out of control, failure to exercise oversight and rein things in. There aren't very many people who I suppose are shocked or should be. There may be some surprise about the rapidity, but the fundamentals, I think, are not much in dispute.

I have just two questions, Doctor, that I would offer up.

One, in a practical matter, how long would it take for the relief, the stabilization, the practical application of a modified proposal, similar to what you have heard the administration's plan morph into, how long would it take for that to actually make a difference on the ground? Not talking about restoring confidence, but in terms of actual operation. Are we talking about 6 weeks? Six months?

Mr. ORSZAG. You mean make an effect, operations in financial markets or out to that household we were discussing?

Mr. BLUMENAUER. In terms of actually administering a program that would take advantage of the authority that we are giving and go in and start the reverse auction if it could be done in a thoughtful way. If you could put the administration in place, if you had the oversight, if you had the workout, are we talking 6 months?

Mr. ORSZAG. I sure hope not. Again, the more that it is focused on, you use the example reverse action for the mortgage-backed securities, the easier it is going to be to design things and get them in place quickly. The more the Federal Government is going to be purchasing individual loans and you are going to have to have a more elaborate process for making sure that you are not overpaying for those loans, the longer it may take.

I would say, in the best-case scenario, you are talking about weeks, not many months. You have to go out and hire the asset managers and then start doing the auctions.

Mr. BLUMENAUER. Yes, but I am seeking an order of magnitude. Are we talking 6 or 8 weeks under best circumstances? Are we talking about 6, 8, 10, 12 weeks?

Mr. ORSZAG. That is going to depend on how stringent the regulations are with regard to, for example, hiring the asset managers. So, if given the current draft the Treasury Department submitted where it is very open-ended, I think they could go out and contract with asset managers very quickly; it would be a low number of weeks. If there are lots of boxes that have to be checked, it may take somewhat longer. So there is a tradeoff between getting oversight and protection and timeliness.

Mr. BLUMENAUER. I guess, Mr. Chairman, I would request—and, again, I don't want—but being able to have some of the certified smart people you work with, just to talk about some of the applications here. You are talking about getting asset managers qualified, how you——

Mr. ORSZAG. Avoid incentive problems for them. There are all sorts of things that are—their compensation.

Mr. BLUMENAUER. Yeah. But getting a sense of what the timing is for things that haven't been filled in. That would be helpful.

Mr. ORSZAG. Okay.

Mr. BLUMENAUER. And I have a suspicion that something we could get in a day or 2 or 3 would still be relevant.

Mr. ORSZAG. Okay.

Mr. BLUMENAUER. My second question deals with what is potentially next, not that it will happen, but recall a few months ago, the furor is over the GSEs and Freddie and Fannie and all of a sudden we are moving in. Then we have AIG exploding and putting hundreds of thousands, millions of annuities at risk. And now, in a matter of hours, we pivot and we have the latest iteration.

I would like, not your saying that it will, but just give us a sense of what are some of the other contingencies that could potentially require a boost in confidence? Hedge fund black holes and instability? We are talking about the auto industry. What are the other contingencies that you think about?

Mr. ORSZAG. That is a frightening prospect to consider. We could walk through all of the financial assets, the trillions and trillions of dollars of financial assets that are held by American households and businesses and that trade on financial markets and potentially raise concerns about the functioning of all those markets.

I can't pinpoint, and I don't think anyone can, you know, out 2 or 3 weeks or 4 weeks or 5 weeks, where the problems may arise without the kind of detailed knowledge—for example, the Federal Reserve does have more information about banks than we at CBO have, because they can go in and examine the underlying books and the trades that they are conducting. We don't have that information.

So, as a little bit of an outsider looking in, it is very difficult to predict what would collapse next. And even the people who have that kind of specialized information have, obviously, had a lot of difficulty doing the same thing.

Mr. BLUMENAUER. But you don't have, for instance, specialized information about what is in large hedge funds, for instance——

Mr. ORSZAG. No, I do not.

Mr. BLUMENAUER [continuing]. That might be heavily leveraged.

Mr. ORSZAG. I do not. I do not.

Mr. BLUMENAUER. But that could be a potential pivot point, theoretically.

Mr. ORSZAG. That is a concern that has often been expressed, yes.

Mr. BLUMENAUER. Mr. Chairman, I would hope that we—and, again, I am not trying to pin down Dr. Orszag necessarily, but it would be helpful to identify the sorts of things that could capture our attention next month or 2 months from now, after we navigate this. And I would respectfully request that——

Chairman SPRATT. We have reporting requirements built in to the bill, which this committee staff, bipartisan, was instrumental in securing in the bill. And it gives us a record of the assets being acquired and an estimate, if I'm not mistaken, of the likely recovery of that asset when it is disposed of.

Mr. BLUMENAUER. Thank you.

Chairman SPRATT. Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

I am sorry I am late. I had another hearing that I was attending. And I apologize if I ask a question that has already been asked or if you have already addressed this issue.

But, from your perspective at CBO, from where you sit, how do we know that $700 billion is the right number?

Mr. ORSZAG. Frankly, we don't. I mean, the bottom line here is that there is a collapse of confidence in financial markets, and the question is what will restore that. In the judgment of the Secretary of the Treasury and the Federal Reserve Chair, $700 billion was the right number. I don't think there is an analytical basis for saying that is the right number versus a trillion or versus $500 billion.

The thing about a collapse of confidence is you never exactly know what restores it. And it is not just the number itself, but lots of other things, including how it is communicated and how it is implemented and what have you that contribute to its success or lack thereof.

Mr. TIBERI. What are the risks for this legislative body to miss the target, either giving too much or giving not enough to that confidence?

Mr. ORSZAG. I would say, at this point, given that we don't exactly know what the right level is and that it is in no small part a confidence game, unless there were some, again, serious justification for altering that number, given that that number is out there, you probably are running a bigger risk by dialing it in either direction than by restructuring the way in which it is implemented.

Mr. TIBERI. What is the risk, from your perspective, of adding to our debt that much more money?

Mr. ORSZAG. It depends crucially on how much the $700 billion goes to overpaying for assets versus paying for them on a fair-value basis. If we simply take the $700 billion and spend it in a way that we are getting roughly $700 billion worth of assets in exchange and on a fair-value basis, then I am much less concerned about the increase in debt, Treasury debt, that is required to finance those purchases because it is basically a swap.

However, if we go out and we buy $700 billion worth of stuff that is actually worth $200 billion and there is reason to think ahead of time that we are overpaying for the assets, that is a much different thing. And that component would cause a deterioration in the Nation's fiscal condition and is similar to regular deficit spending.

Mr. TIBERI. So, if you were the king of the legislature, which obviously you are not, but you are the king at CBO, how do we in the legislative body try to make sure that doesn't happen? How do we protect that from happening, from your perspective?

Mr. ORSZAG. Well, if one wanted to make sure you were getting fair value for what you are purchasing, there are ways, for example, restricting the program to reverse auctions on a tranche-by-tranche basis for mortgage-backed securities and other things that we could lay out, that are more likely to get you fair value.

And then there are asset categories and ways of conducting these transactions that are more likely to make you overpay. For example, buying individual loans from banks is likely to result in the Federal Government overpaying for those loans if it is done through a reverse auction. Because you are going to likely wind up with the riskiest part of the loan portfolios and not getting sufficiently low prices for bearing those risks.

Mr. TIBERI. Particularly if you are buying——

Mr. ORSZAG. Taking those risks, I should say.

Mr. TIBERI. Particularly if you are just buying the bad loans and the junk, right?

Mr. ORSZAG. And not getting a sufficient discount for doing that, yes.

Mr. TIBERI. Okay. Thank you.

I yield back.

Chairman SPRATT. Mr. Scott of Virginia?

Mr. SCOTT. Thank you, Mr. Chairman.

And thank you, Dr. Orszag.

You have indicated in your testimony that CBO cannot provide a meaningful estimate of the ultimate net cost of the administration's proposal, and in response to the latest questions, within a couple of hundred billion dollars one way or the other, it seems.

Now, we have been told that the public ought to be scared if we do nothing. It seems to me we ought to ascertain how scared they ought to be if we spend $700 billion without a meaningful estimate of the ultimate net cost.

So let me ask you a question. If enough work has been done on a loan portfolio, billions of dollars' worth of home mortgages for example, it seems to me we can take a statistically significant sample of that to find out the value of that portfolio by looking first at the face value of the mortgages, the interest rate, the creditworthiness of the borrowers, the real value of the collateral, and you can estimate the payments to maturity even after defaults are considered. You can apply a reasonable discount rate to get a yield to maturity.

If you had that information, could you provide a meaningful estimate of the net cost to the administration's proposal?

Mr. ORSZAG. Well, yes, although—and that is what private purchasers of a mortgage-backed security do. They try to project out the cash flow and whether the current pricing is above and below.

But here is the key thing: If an asset manager is hired by the Federal Government to purchase that thing for us and doesn't bear its own risk from making that purchase, I think the question is do they have the same incentives as if they were purchasing it for their own books and whether the same standards will be applied.

And, furthermore, if you do it through a reverse auction, that kind of same scrutiny isn't necessarily applied to each mortgage-backed security.

Mr. SCOTT. Well, it seems to me, if we did some perfunctory due diligence, we could figure out a good idea of what these things are worth. And without the information—because we don't know the collateral behind these things. We do know that the collateral may not be sufficient on a lot of these loans. We do know that the borrower's creditworthiness wasn't checked. And we are trying to figure out what these things are worth without the perfunctory information.

I mean, doesn't that insult your intelligence to be asked to comment on a plan where you don't know what you are getting or how much you are going to pay for it?

Mr. ORSZAG. I don't know that I would frame it as insulting my intelligence, but I can't do it.

Mr. SCOTT. Well, let me ask you another way—well, yeah, you can't do it.

Mr. ORSZAG. Yeah. There is not enough specificity to do this right now.

Mr. SCOTT. Now, if we don't know what we are doing for mortgage-backed securities, for which you can really get a good value—I understand the first plan had limited us to mortgage-backed securities; the next is anything he wants to buy.

Is there any reason to go past mortgage-backed securities?

Mr. ORSZAG. Well, the first plan didn't quite limit it to mortgage-backed securities. It limited it to mortgage-related assets, which can be a whole array of different things.

Mr. SCOTT. Is there any reason to go past that?

Mr. ORSZAG. I think the argument to go past that would come back to the question Mr. Blumenauer asked, which is we don't know what will implode next. And if you want to do this on a one-off, kind of, give the Secretary authority to go fight fires wherever they may occur, the fires may occur outside of mortgage-related assets.

Mr. SCOTT. Generally accepted accounting principles on book value, should the book value on the corporate books have good face value purchase price or what?

Mr. ORSZAG. I think, in general—and there is some controversy over this—but, in general, there are benefits to marking to market. Book value doesn't always reflect market values. There have been concerns that have been raised about marking to market during particularly volatile financial market times like we are experiencing today.

Mr. SCOTT. Okay. So it is not always—it is kind of artistic, is what you are saying.

You indicated that if liquidity alone is the problem, those companies that have good assets for their liabilities, if that is all we are solving, we could do this, we could solve the liquidity problem without much net cost to the Government. But solving people's insolvency problem, where they are actually bankrupt, ought to be a separate question.

Mr. ORSZAG. That is correct.

Mr. SCOTT. Okay. On this reverse auction, it seems to me that if nobody knows down deep what is behind these things, if the seller did a little due diligence and figured it out, we would be buying blind, they would be selling with knowledge. Isn't that a recipe for getting ripped off?

Mr. ORSZAG. Yes, if what the sellers are offering you are different things. And if instead—and this is what at least part of the Treasury program is likely to entail—if instead you have different owners of the same thing, so you have some given cash flow that is split among 100 different institutions, if they are the ones bidding, you are only bidding on their shares, then you don't have that problem.

Mr. SCOTT. Well, you only have the problem to the extent that they know what they have and you are trusting them to try to bid against each other to try to get a fair value, and you hope they know what it is worth, and you would come out.

But isn't a due diligence, reasonable yield to maturity, isn't knowing that number essential to know what you are buying?

Mr. ORSZAG. Again, it depends on the context. More confidence in the scenario we just discussed of the competitive bidding process would give you the best guess of what that underlying value is.

In other cases, where they are offering different things, then, yeah, you have this problem that you have to, in a sense, value each individual asset that people are offering to sell you.

Mr. SCOTT. So you know what you are buying.

Mr. ORSZAG. So you know what you are buying.

Mr. SCOTT. Isn't that a good idea, to know what you are buying?

Mr. ORSZAG. In general, it is a good idea to know what you are buying, if you want to avoid overpaying.

Mr. SCOTT. Your whole analysis is such that, if you don't overpay, you will have, at most, a wash and, at best, a profit. If you overpay, you could be getting ripped off. And we are going to spend $700 billion without knowing what we are doing.

Mr. ORSZAG. And I think one concern is it is not clear to the degree to which we are trying to address—you know, we are trying to overpay. And, in fact, some of the comments that were made yesterday suggest perhaps we want to overpay, to provide support to financial institutions, versus just simply trying to restore liquidity to markets, which need not imply any significant overpayment. And I think it is important to figure out which one we are trying to do.

Mr. SCOTT. And it would be nice to know what we are doing before we spend $700 billion doing it.

Chairman SPRATT. Thank you, Mr. Scott.

Mr. Etheridge?

We have about 10 minutes until votes, and I want to see that everybody gets a chance.

Mr. Etheridge?

Mr. ETHERIDGE. Thank you, Mr. Chairman, and let me thank you for holding this hearing.

Mr. Orszag, thank you for being here.

Let me go back to a little more personal, on Main Street on this, with the budget implications. Friday night I was at a Boosters Club banquet with a bunch of folks. Talked to a builder. He is down to two people from 30. Talked to bankers over the last several days with regional banks. They are no longer making any loans, because they are concerned they are not moving money, as you said earlier, from bank to bank.

And I guess the other part of it is many of us feel like we are riding the back of the tiger and we are not sure where the tiger is headed. And we don't want to hop off, but we are afraid to—you know, we just feel like we are riding without a roadmap.

So my question is, I was in business for 19 years—and you touched on it earlier. I wanted to go back to that, because I think what we are doing, the effects or where we get to, businesses not only borrow money for raw materials, they have to borrow money for inventory, for storage in some cases, for that equipment or product that is moving. And that hasn't come back to pay their salaries.

It is now September, mid-September. A lot of businesses have already booked their purchases for the holiday season or are in the process of it, needing money to pay for that inventory with anticipation of the holidays. Talk to us, if you will, about the impact on the budget on this issue.

If that seizes up, the inventory doesn't move, they can't get it, some of it may be there, but the consumer has a problem with their personal finances, and then all of a sudden we have a horrible holiday season that bleeds into a new budget year.

Mr. ORSZAG. That is exactly the scenario that is of most concern, in terms of, you know, real people and the downward spiral that would follow.

I would note one small silver lining, which is not to downplay the seriousness of the problems that we face, but it is the case that corporations as a whole have built up their cash reserves in part because they are coming off of many years of relatively high profits and in part because there were indications that credit markets may start experiencing difficulty.

So that does provide them a bit of wiggle room for some period of time to draw down those cash reserves while other sources of liquidity are drying up. But, ultimately, if the financial market problems are perpetuated, they will become a very severe constraint and cause problems not just for the Federal budget but for the economy as a whole.

Mr. ETHERIDGE. Well, let me go a step farther, because you are talking about the large corporate entity.

Mr. ORSZAG. Yeah.

Mr. ETHERIDGE. In a lot of parts of this country, it is the small businesses that——

Mr. ORSZAG. They tend not to be sitting on as much cash.

Mr. ETHERIDGE. Yeah, and they are going to the banks monthly, bimonthly and, in some cases, even weekly to move it through. And that is affecting Main Street big time. When that gets tied up, then the whole process affects the big corporations. They may be sitting on cash, but they don't buy their product, and it doesn't move.

And now we have counties and cities going through tax re-evaluations with the housing market going down. That is going to have a significant impact on the ability of the local institutions of government to provide the services that they need to provide. And that ultimately will impact our budget again, correct?

Mr. ORSZAG. Yes. Again, we will—it is highly desirable to avoid the downward spiral that could follow from failing to address this crisis of confidence in financial markets.

Mr. ETHERIDGE. It seems to me, Mr. Chairman, the challenge we face is trying to get something right, you know, and understanding where we are.

I thank you very much, and I yield back.

Chairman SPRATT. We are going to try to give everybody a chance, but I need to get one thing on the record.

Mr. Orszag, would you like to take 30 seconds and explain why you need additional funding for your responsibilities?

Mr. ORSZAG. Yeah. The legislation requires that CBO would report to the Congress on a quarterly basis on the net cost of this program to the Federal Government. For us to do that well, given the wide array of assets that are likely to be involved in the program and the kind of modeling that was discussed earlier, we need some more people who are expert at that. And we may also be given a huge array of data on all of the individual assets, and we need some capacity to be able to process that data, which we currently lack.

Or another way of putting is, it is obviously up to you in terms of whether you want us to play this role. But if you want that kind of reporting, regular reporting, from us on this complicated program, we don't currently have the resources to do it.

Chairman SPRATT. We think we do want that role fulfilled, and particularly by CBO because we have the closest relationship with you. So thank you for putting that on the record.

Now Mr. Baird.

Mr. BAIRD. I want to thank Mr. Orszag. He is all on the mark, tells us what he knows, what he doesn't know, and is tremendously informative.

My friend, Mr. Blumenauer, from Oregon raised the issue of what might be on the horizon. For some time, I have personally been greatly concerned about the ARM reset issue. A great number of Americans took out ARMs or other devices and, instead of lowering their debt-to-equity ratio, increased it. And ads were come-ons to do that.

Is anybody giving some thought to what happens as millions of Americans who, at current, have a net negative savings rate suddenly see an ARM kick in from $500 to a $1,000 a month more than their current mortgage, and what that has? Is that the next wave? We seem to be always behind the waves. Are people looking at that? And how can we get ahead of that?

Mr. ORSZAG. As you may know, and I am sure you do, that was a significant concern a year or 2 years ago, as we were looking into the eye of this. Those concerns, while they are still there to some degree, have attenuated somewhat, in part because the Federal Reserve has acted so aggressively to reduce interest rates that the resets aren't as severe as many people feared, you know, let's say, 2 years ago.

So it is still there, but I think it doesn't loom as large as a concern as it did a couple years ago, in part because overall interest rates, especially on the short-term end of things, have declined so dramatically.

Mr. BAIRD. Okay.

My second question is, if you look at how we got into this, it is because, in a nutshell, many firms vastly overleveraged. They had much more outstanding debt than they had collateral to cover it.

To some extent, that is analogous to what the Federal Government is doing. We have $9.4 trillion debt, rapidly heading to $9.5 trillion, it looks like, and maybe more. Some of us feel we ought to pay for this.

During the last 8 years, the administration has not once come to this Congress and said, "This is how we are going to pay for something." And some of us feel that the people who got vast wealth and income out of creating the conditions that now are plaguing our country ought to be the ones who pay for it, not the average guy on Main Street and back home who has been paying his taxes, paying his mortgage, going to work every day, but the guys who are pulling in $25 million golden parachutes.

Can you give us a ballpark estimate of how much revenue could be generated if we just put a modest tax increase on people with, let's say, $2-million-a-year-plus income?

I seem to remember, a few months back, we were looking at funding the GI bill. My recollection was a one-half of 1 percent tax increase on people with incomes over a million or so a year. Beyond the million generated $50 billion over 5 years, ballpark. My memory may be wrong.

How much can we generate from even a modest increase on the people who are most well-to-do, so we don't pass this burden on the average taxpayer?

Mr. ORSZAG. Let me say two things.

First, again, to the extent that you are purchasing assets at fair prices, in a sense that pays for itself, or there is no net expected cost. When you are subsidizing the purchases, when you are overpaying and thereby providing a subsidy to financial institutions, that is where the expected costs come in.

There are a variety of ways that, if you wanted to pay for it, you could. High-end income taxation is one possibility. I don't remember the exact numbers which came from the Joint Committee on Taxation, but we can get them to you.

Mr. BAIRD. The problem some of us have, as you read the articles, and it says the plan from Treasury is to rescue these companies by buying their bad debt. A guy comes up to me and says, "Hey, buddy, want to buy some bad debt?" I am going to say, "No, I would rather buy some good debt, thank you very much."

So, on the one hand, we are told, oh, this won't cost very much because you are buying real assets. On the other hand, we are told, but you are buying the bad real assets.

Mr. ORSZAG. And the key thing is, what is the price at which you are buying that bad debt? If someone comes up to you and says, I have this bad loan and I am going to give you a huge discount, it might be worth it to you.

And so that is why I was emphasizing so much are we overpaying or not, how are those prices being determined. It is not necessarily the bad debt itself but, rather, the price that you are paying for the bad debt that becomes the issue.

Mr. BAIRD. The other two key questions are, who is going to benefit from me buying it, and why should I buy something to help somebody out? They are not just coming to say, buy the bad debt; they are saying, buy the bad debt so all these CEOs who made so much money driving these companies into the dirt—and they justified these big incomes on, well, we have a lot of responsibility. Well, they botched their responsibility, and the average taxpayer says to me, why should I bail them out?

I thank the gentleman.

Chairman SPRATT. Ms. Kaptur?

Ms. KAPTUR. Thank you, Mr. Chairman, very much. Thank you for allowing me to meet my responsibilities as a member of this committee in Congress.

Dr. Orszag, thank you so much for coming today.

My goal is prosperity and jobs on Main Streets across this country, with a power shift, an economic power shift, from Wall Street and this city of Washington back to Main Street. I am asking myself how to do it as we face this situation.

The very best book that I have read that puts this into perspective is by Kevin Phillips, chapters 8 and 9 of his book, "American Theocracy." I am going to ask the chairman to place chapters 8 and 9 in the record, the first called "Borrowed Prosperity and the Financialization of the U.S. Economy," and chapter 9, "Debt."

I believe we find ourselves in the predicament that we do because there has been a tremendous power shift from Main Street to Wall Street and to this city of Washington. It is too concentrated, and it is too intangible.

I support reform of our financial structure, reform, before any taxpayer support goes out the door, to especially the financial services sector. FDR figured it out; we should too. And my feeling is we shouldn't adjourn and go home to campaign until we meet our responsibilities to the American people.

Now, let me put this in some perspective. About a century ago, Britain, as it continued to decline in power, its colonial secretary said, "Banking is not the creator of our prosperity, but the creation of it." He understood the difference between money and wealth, and that trading abstract financial instruments was different than the production of real, tangible goods and services that create real, tangible wealth.

Now, Phillips, on page 266 of this excellent book, states, "By 2004, financial firms in our country boasted nearly 40 percent of all U.S. profits, up from just 6 percent in 1980 and 11 percent in 1990, while the manufacturing sector fell from over 60 percent of profits down to less than 10."

Part of that is because this very financial sector has been outsourcing our jobs all over creation and outsourcing the purchase of our bonds to foreign countries. So we are losing control as our economy is being globalized.

My question is whether propping up paper money is the best expenditure of our Nation if our goal is prosperity, jobs and tangible, real wealth on every Main Street across our country. My purpose is to create wealth, not just paper money.

And let me just finally say that, if we look at the 1980s—and I served here back then—after the Resolution Trust Corporation was set up after the imprudent behavior of the banking sector, rather than tightening controls and returning power to Main Street, we did exactly the reverse. The imprudent institutions were actually allowed to become more imprudent. Investment houses created money without underlying assets. And the old, time-honored principles of character and collectability and collateral at the local level, where we had had local savings banks with deposits, with passbooks that paid interest, and then they made loans, we totally reversed that and we changed loans to bonds and securitized them into this highly debt-structured market.

And we saw this huge power shift from Main Street to Wall Street. And now they are coming to us and saying, “Oh, bail us out,” when, in fact, I am saying I am not sure the financial sector is the sector I want to bail out. I want to produce real money.

We did interstate banking; I voted “no” on that. Again, to create these mega-giants that move power and money elsewhere and decision-making elsewhere with imprudent standards. In 1994, they took the name “Banking Committee” off the committee in this very House, and they changed it to “Financial Services” to empower the very folks that did this to us. In 1999—I have many examples—Glass-Steagall was removed; the historic separation between banking, commerce and insurance was removed.

And my question really is, as we do this, how do we restructure the bigger picture to return financial power and responsibility to Main Street and to recreate the institutions Franklin Delano Roosevelt understood well—local community banks with prudent lending standards? He had the Homeownership Loan Corporation to restructure the bad debt, which is what they are asking us to do now.

Why can’t we do that? Why do we have to bail out those who created phony money?

Mr. ORSZAG. I think, again, there are two issues. One is the immediate problems that the crisis of confidence in financial market seems to entail, and the second is the regulatory structure on a going-forward basis.

In my opinion, for whatever it is worth, I am not sure that we have the time to make the underlying regulatory changes, whether they are of the kind that you favor or others of your colleagues favor, before addressing the concerns surrounding the collapse of confidence in the financial markets. And, by the way, especially——

Ms. KAPTUR. May I just say this, Mr. Chairman? And that is what troubles me about this whole discussion, because I hear these pundits on TV, these guys who come up over to the Senate from the administration, they always say, “We want the money before the reform.” I say, the reverse. Roosevelt figured it out under much more difficult conditions. So should we.

I thank you, Dr. Orszag.

Chairman SPRATT. Thank you, Ms. Kaptur.

Mr. Boyd, I am prepared to miss the vote so that, Mr. Boyd, you can go ahead and put your questions in. I think it is a procedural vote. And if you would like to do the same, we will proceed.

Mr. BOYD. All right. I would like to proceed, Mr. Chairman. Thank you.

Chairman SPRATT. Mr. Boyd, you are recognized.

Mr. BOYD. Dr. Orszag, thank you for your service. And I apologize for being late, too. So if I ask something that you have already answered, please indulge me and forgive me.

And I want to start by saying that I am, to sort of spin off what Ms. Kaptur said, I am extremely skeptical about whether this is the right thing to do. That skepticism I think comes from the fact that I am concerned that we may be treating the symptom and not the underlying cause for the problem.

But I want your counsel and advice in one specific area, and I want to talk about the devaluation of the dollar and the role that has played in all of this. I don't think it is complicated that most economists would tell you that the devaluation of the dollar, the primary cause is government deficit spending.

In this proposal, what role—or what will that do, in terms of the value of the dollar worldwide?

Mr. ORSZAG. Well, again, let's back up. The dollar has been—actually, frankly, even though this may sound ironic, one of the silver linings or one of the things that has been going relatively well during the economic challenges we have been facing over the past year or 2 is that the depreciation of the dollar, which had to occur, has been going relatively smoothly. In other words, the foreign exchange markets have not experienced the same kind of crisis that some of our overnight lending markets are now experiencing.

So that decline in the dollar, which has had to occur because we have been borrowing an unsustainable amount of funds from abroad, has occurred relatively smoothly. And everything is a relative statement.

What will happen from this kind of legislation, it depends on, again, the degree to which market participants believe we are overpaying for the assets that we are obtaining.

To the degree that we are overpaying, that is a deterioration in the underlying condition, fiscal condition, of the Federal Government. And the same forces that then can lead to concerns about both national saving and all the other things that feed into the normal dynamic of potential depreciation could apply.

To the extent we are just simply purchasing assets that are worth what we are paying for them, at least in a purely rational way, that really shouldn't have any significant effect on the U.S. dollar. Whether financial markets, because of psychological reasons or others, perceive it that way is an entirely different question. That is sort of a textbook answer.

Mr. BOYD. With the existing underlying reasons for this—and a lot of folks have talked about—Ms. Kaptur talked about the abstract financial instruments, the derivatives and all of that, which obviously play a role in all of this. With the infusion of $700 billion of money, I assume most of it will be borrowed, and that gets rolled numerous times, does that exacerbate the devaluation-of-the-dollar problem around the world?

Mr. ORSZAG. Well, what I would say is we have not experienced, and I don't anticipate experiencing, any problems raising the $700 billion or rolling it over regularly. But just like financial market institutions that had gotten in the habit and gotten used to regularly rolling over their short-term obligation, one problem with a higher outstanding stock of government debt, which does have to get rolled over, is if in the future, for whatever reason, there were confidence problems or other difficulties in the Treasury market, having a higher outstanding stock of government debt that has to be rolled over would exacerbate the problems that we would face.

Mr. BOYD. Okay. All right. Can you help me with my extreme skepticism about whether this is the right thing to do?

I mean, you know, John Spratt, Marcy Kaptur and myself, others, have certainly lived with parents who came out of the Depression, and our lives were shaped at a very young age, obviously, by that experience, their experience. And it is something that we thought we had put tools in place to keep from happening again.

So can you calm my extreme skepticism about what we should do?

Mr. ORSZAG. Yeah, let me say two things.

One important contributor to the Great Depression was policymakers who not only failed to act but actually, in some sense, often did counterproductive things. And I think, luckily, there is at least a mentality now that will avoid some of the worst problems associated with policy in the late 1920s and early 1930s. So that is the first thing.

The second thing is fundamentally you are asking will the $700 billion work. And I don't know the answer to that, because, again, it comes back to this question that a fundamental driver of what is happening is a collapse of confidence. Whether the $700 billion restores confidence or not, I don't know.

And, by the way, it is hard to know even without knowing—again, we don't know how the program will be implemented with any granularity. So I think it is an open question.

But I also think that is a separate question from whether or not you should do it. It may not work, but if you do nothing, it definitely won't work.

So what you do is up to you. But I think, at this point, unfortunately, especially having created the expectation in financial markets that you will do something, doing nothing would likely be a very serious mistake.

Mr. BOYD. Mr. Chairman, may I ask one last short question? The great debate here about $700 billion infusion versus the regulatory reforms, oversight reforms, those kinds of things, if you were sitting in Congress would you vote to extend the money without doing the other first.

Mr. ORSZAG. Am I allowed to say thank goodness I am not sitting in Congress? Look, I mean, you face a difficult situation in the sense that time is of the essence here. And I think it has to be correct that it would be nice to be able to do—you know, not give desert before you have eaten your vegetables.

But the question is whether you have the time to do that. And that is obviously an internal dynamic that I shouldn't comment.

Ms. KAPTUR. Would the gentleman yield on that?

Mr. BOYD. Certainly.

Ms. KAPTUR. Mr. Chairman, I don't know if this is in the purview of our committee, but Dr. Orszag is so excellent and his staff and your staff, Tom, would it be possible for us just to have a brownbag lunch sometime and look back at the 1930s; what was done quickly in order to stem the hemorrhage?

Chairman SPRATT. Sure we can do that. We can look back to the 1980s and what was done with Lockheed, Chrysler, Penn Central and all of those cases that are somewhat success stories because the loans and the guarantees were ultimately paid and warranties, and the warrants at least in the case of Chrysler resulted in profits.

Ms. KAPTUR. Thank you, Mr. Chairman. One of the characteristics of the three that you mentioned is they all had tangible hard assets. What we are dealing with here is phony money.

Chairman SPRATT. That is a very good point.

Ms. KAPTUR. That discussion is one I would love to have in more depth, and I have the highest respect for you. Thank you.

Chairman SPRATT. If we stop now and hustle to the floor, we may still make the vote.

Mr. BOYD. I have one quick question. Did I understand you to say you were advocating for a reverse auction process if we go through this?

Mr. ORSZAG. I don't advocate for anything. But if you want to obtain a fair price for what you are buying, limiting things to reverse auctions on a given cash flow that is distributed across many potential owners accomplishes that objective. Other asset classes and other ways of doing it doesn't.

Chairman SPRATT. Dr. Orszag, as always, thank you very much. In particular in this case, your testimony was excellent help to the committee. We very much appreciate it.

[Whereupon, at 12:12 p.m., the committee was adjourned.]

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